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HYBRID MISMATCH.COM: NEUTRALIZING THE TAX EFFECTS OF HYBRID MISMATCH ARRANGEMENTS

by

Maria S. Domingo[*]

I. INTRODUCTION

One reality is as certain as taxes: when people—even accountants—think of taxes, dating is not the first topic to come to mind. Oddly enough, though, what follows closely resembles today's online dating phenomenon (at least as closely as tax ever could).

What began as personals or personal ads, first printed in local newspapers, have evolved into global online dating services, which are now commonly used by individuals who are looking to find their "perfect match." These services provide subscription dating products around the world through websites and mobile applications that help individuals in their quest to find and develop a meaningful connection.[1] Online dating includes search and matching features that enable users to search profiles, receive algorithmic matches and may use location-based technology—the mix of these features is "constantly subject to iteration and evolution" in response to "competitors' offerings, user requirements, social trends and the technological landscape."[2] In the digital world, online dating, akin to a present

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day matchmaker, has yielded favorable outcomes for many of its users and produced lucrative business results.[3]

Much like individuals looking to find their "perfect match," multinational enterprises (MNEs) have found connections in the tax laws of various jurisdictions to develop the perfect *mis*match in their cross-border transactions, which until recently has produced favorable outcomes for MNEs and lucrative tax savings. Consistent with the premise that "opposites attract," hybrid mismatch arrangements use the differences in the tax treatment of financial instruments, entities or transfers to create favorable asymmetrical tax effects between countries that are part of the same transaction. The mismatch can result in a deduction with no corresponding income inclusion or even a double deduction that erodes the MNEs' tax bases in the applicable jurisdictions and substantially reduces their aggregate tax burden. In a globalized world, governments need to consider how different tax regimes interact with each other in cross-border activities and the overall tax effect of these transactions. As part of the Tax Cuts and Jobs Act, the United States has codified key provisions (in line with the OECD's Base Erosion and Profit Shifting Plan) meant to shut down the effects of hybrid mismatch arrangements. However, different tax jurisdictions have divergent interests and reason follows that each country's goal is to protect its tax revenue. Absent global minimum standards, how long before taxpayers evolve with another iteration of tax strategies that work around anti-hybrid recommendations in perhaps more amenable locales or jurisdictions?

The remainder of this article proceeds as follows: Part II provides background regarding the U.S. worldwide tax system (prior to Pub. L. 115-97) compared to the territorial tax system. Parts III and IV provide an overview of hybrid mismatch arrangements and discuss tax policy issues. Part V navigates

through the key provisions of the Tax Cuts and Jobs Act that directly impact hybrid mismatch arrangements and discusses proposals for reform. Lastly, Part VI concludes.

II. TAX REGIMES

Background – U.S. Tax System

U.S. international transactions are generally divided into two broad categories for tax purposes: outbound transactions and inbound transactions. Outbound transactions involve U.S. citizens and residents (including domestic corporations created or organized in the U.S.) doing business and/or investing abroad; as inbound transactions involve foreign taxpayers (nonresident aliens and foreign corporations) doing business and/or investing in the U.S.

Outbound Transactions:

From a U.S. tax perspective, "outbound" pertains to U.S. persons, i.e., individuals or entities with foreign source income and/or that engage in activities outside of the U.S. Prior to the Tax Cuts and Jobs Act of 2017 ("TCJA"),[4] the U.S. imposed a "worldwide" tax system (or residence-based system) in which domestic corporations were subject to U.S. tax on a worldwide basis. In general, domestic corporations were subject to U.S. income tax on all income irrespective of whether the corporation derived income from a U.S. source[5] or a foreign source. The U.S. imposed entity-level taxation on a C corporation's taxable income at statutory federal income tax rates of up to 35%. To ameliorate the potential for double taxation that may result from U.S. taxes imposed on a domestic corporation's foreign source income, the domestic corporation could claim a foreign tax credit for income taxes already paid to foreign countries, subject to certain limitations.[6]

A domestic parent corporation was subject to U.S. tax when its foreign corporate subsidiaries (which conduct foreign operations) repatriated their earnings as dividend distributions to the U.S. parent corporation. As a result, the U.S. tax on such income was generally deferred until the foreign subsidiary repatriated the income—that is, U.S. multinationals could defer U.S. tax indefinitely on their foreign subsidiaries' active income until the foreign subsidiary repatriated the income as a dividend to the U.S. parent corporation.[7] Under Subpart F[8] prior to its amendment under TCJA and the passive foreign investment company[9] provisions of the Internal Revenue Code (anti-deferral tax provisions), the domestic parent corporation was subject to immediate U.S. tax only on certain items that its foreign subsidiaries earned as passive income (e.g., interest, dividends, annuities, rents and royalties) or highly mobile income regardless of whether the foreign subsidiaries distributed the income as a dividend to their U.S. parent corporation. The Subpart F provisions, in essence, treated certain passive income of a controlled foreign corporation as a deemed dividend to its U.S. parent subject to immediate U.S. taxation (i.e., no deferral until repatriation).

Simply put, a U.S. multinational company was subject to U.S. tax on its worldwide income reduced by foreign tax credits and active foreign profits (e.g., foreign subsidiary's earnings) only upon repatriation to a U.S. parent. As a result, multinational enterprises ("MNEs") implemented tax strategies to shift profits from the U.S.[10] to no-tax or low-tax jurisdictions.

Inbound Transactions:

From a U.S. tax perspective, "inbound" pertains to non-U.S. persons, i.e., individuals and entities with U.S. income and/or that engage in U.S. activities—including, for example, a

foreign corporation with U.S. source income and/or U.S. activities. Prior to the TCJA, foreign corporations were subject to U.S. tax only on income with sufficient nexus to the U.S., i.e., income "effectively connected" with the conduct of a trade or business in the U.S. In other words, the U.S. taxes a foreign corporation's income generated within U.S. borders. "Effectively connected income" generally requires that the taxpayer have a physical presence or use assets in the U.S., and such income is taxed the same as income of a U.S. corporation (e.g., same tax rates). However, tax treaties between the U.S. and the applicable foreign country may cap the amount of U.S. tax on a foreign subsidiary's income.[11] Moreover, foreign corporations are still generally subject to a U.S. withholding tax of 30% on interest, dividends, rents, royalties and certain types of income from U.S. sources, which a treaty may also decrease or eliminate.

Territorial Tax

Many other countries have adopted the "territorial" tax system (or source-based tax system), in which a country taxes an MNE's income sourced only within its borders, i.e., income earned within the country's tax jurisdiction. Foreign source income (i.e., income generated outside of the country's borders) is not subject to tax by the corporation's country of residence under this system. Therefore, the territorial tax system generally exempts from taxation the distributions of controlled foreign subsidiaries. As such, it is important for countries that have implemented a territorial tax regime to determine accurately the source of a multinational's revenues and expenses. Pursuant to the participation exemption,[12] the U.S. has recently made strides toward a territorial tax system via a 100% dividends-received deduction on certain foreign source income distributed to U.S. corporate shareholders.

III. HYBRID MISMATCH ARRANGEMENTS

In recent years, governments have become increasingly alarmed by MNEs' use of aggressive tax planning in their cross-border transactions.[13] The practical reality is that a multinational corporate group functions more akin to a single undivided organization rather than separate individual organizations—that is, the parent corporation may strategically coordinate its direct or indirect control of subsidiaries and/or affiliates to reduce overall taxes of the group and thereby increase profitability as a whole.[14] Revenue authorities and tax policy makers have expressed concerns about the difficulty of taxing MNEs engaged in cross-border activities (e.g., lack of transparency, increased level of complexity and sophistication in structuring cross-border transactions) and a rise in BEPS.[15] The different tax regimes of multiple jurisdictions have resulted in asymmetrical tax effects between countries that are part of the same transaction. This asymmetry, in turn, enables taxpayers to engage in base erosion and profit shifting.[16] Therefore, it is imperative in a globalized world for governments to consider how different tax regimes interact with each other in cross-border activities and the overall tax effect of these transactions.[17]

In an effort to neutralize aggressive tax planning, the Organization of Economic Cooperation and Development ("OECD")[18] and G20[19] countries have adopted a 15 Action Item plan to address BEPS. In 2015, the OECD issued final reports on the 15 Action Items, which aim to ensure that profits are taxed in the jurisdiction where the MNEs performed the economic activities that produced such profits and where value was created.[20] Interestingly, the OECD's recommendations require that one country (to determine its own tax treatment) take into consideration the taxpayer's position and tax treatment in another country. This view is generally alien to legislators in most jurisdictions whose primary concern is to protect their own

country's tax base. In particular, Action 2 provides recommendations for domestic law and tax treaty provisions to neutralize the effects of hybrid mismatch arrangements. In a surprise move, the U.S. has more recently enacted legislation that adopts a number of the OECD's recommendations. But are these recommendations enough to curtail these arrangements?

What are hybrid mismatch arrangements?

Hybrid mismatch arrangements are cross-border transactions that exploit the differences in the tax treatment of financial instruments, entities or transfers between two or more tax regimes. These arrangements both comply with the tax laws of the applicable jurisdictions and yet, use the very same laws to erode the tax bases in these countries. Oftentimes to the benefit of the taxpayer (and detriment of revenue authorities), these arrangements may result in "double non-taxation" or tax deferral. Hybrid mismatch arrangements can substantially reduce the aggregate tax burden of MNEs that are engaged in these transactions.[21] The structured arrangements generally use hybrid financial instruments, hybrid transfers, and/or hybrid entities to achieve (1) a deduction with no corresponding income inclusion ("D/NI"), (2) a double deduction ("DD"), (3) an indirect D/NI or (4) foreign tax credits.

Specifically, D/NI arrangements create a deduction in the payer jurisdiction (e.g., interest expense, which erodes the MNE's tax base in that country) without a corresponding inclusion in the payee's ordinary income by a second country that is involved in the same transaction. Simply put, a multinational group deducts a payment under the tax system of the payer jurisdiction without a requisite inclusion in the payee's ordinary income. In DD arrangements, the MNE claims an income tax deduction for the same contractual obligation in two different jurisdictions—that is, multiple deductions are claimed

for a single expense. Foreign tax credit generator arrangements enable MNEs to generate foreign tax credits that would otherwise be unavailable (e.g., generate multiple foreign tax credits for one amount of foreign tax paid). Indirect D/NI arrangements involve payments that are deductible in the payer jurisdiction, which the payee then offsets against a deduction under a hybrid mismatch arrangement. Accordingly, hybrid mismatch arrangements reduce the taxpayer's collective tax base resulting in significant overall tax savings.[22]

Cross-border conflicts in the characterization of a payment between multiple jurisdictions can result in tax mismatches of sorts. The OECD's recommendations are "linking rules" intended to align one tax jurisdiction's treatment of a hybrid financial instrument or hybrid entity with the tax consequences in the counterparty jurisdiction to the transaction. The rationale behind the recommendations is to "ensure matching of income and deductions across international boundaries."[23] The OECD divides the recommendations into a primary response and secondary/defensive rule where the defensive rule is administered only if the other jurisdiction lacks a hybrid mismatch rule or the jurisdiction does not apply the rule to the arrangement.[24] The rules focus on the payments and whether the characterization of the payment results in a deduction for the payer and income recognition for the payee. In general, the primary rule provides that the payer jurisdiction deny the taxpayer's deduction for a payment if the payment is excluded from payee's (recipient) taxable income in the counterparty jurisdiction or the counterparty jurisdiction also permits a deduction for the same payment. If the payer's jurisdiction does not apply the primary rule, then the counterparty jurisdiction may apply the defensive rule, which requires the payee to include the amount as income or deny the duplicate deduction.[25] In order for these rules to apply, a hybrid

element must bring about the mismatch in tax outcomes in the first place.

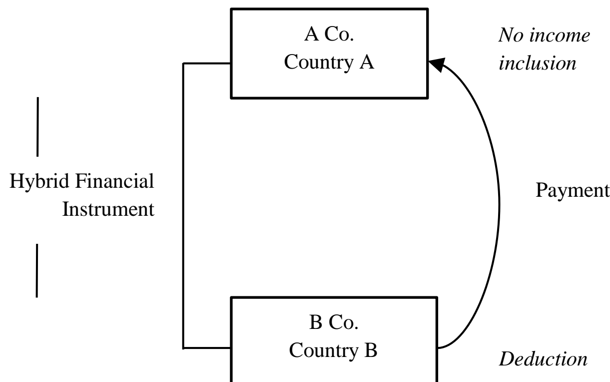
The OECD's approach is to provide recommendations upon which each country can legislate domestically in a consistent and coherent manner with other jurisdictions. The following discusses simplified examples[26] of hybrid mismatch arrangements to illustrate their overall tax effect along with the OECD's recommendations for domestic law to counteract these transactions.

Hybrid Financial Instruments:

Hybrid financial instruments are instruments that two or more countries involved in the same transaction treat differently for tax purposes because of a conflict in the tax jurisdictions' characterizations of the instrument. For example, the instrument is considered debt in one jurisdiction and equity in another jurisdiction. In other words, the jurisdictions differ in their tax treatment of the same payment, which the taxpayer makes under the instrument. In the following example, an MNE uses a hybrid financial instrument to achieve a favorable D/NI result.

Example 1:[27] A Co., a resident of Country A, owns 100% of B Co., a resident of Country B. Country A's domestic law exempts dividends paid by a foreign company if its shareholder held greater than 10% of the company's shares in the 12-month period before the foreign company pays the dividend. Country A has no law in place that denies the dividend exemption in the payee jurisdiction (Country A) for payments that are deducted in the payer's jurisdiction (Country B). In other words, Country A has no law in place that denies A Co. the dividend exemption in Country A for payments that B Co. deducts in Country B. B Co. borrows money from A Co. via a hybrid financial instrument. The terms of the loan require

a market interest rate payable every six months in arrears. B Co.'s interest and principal payments under the loan are subordinated to B Co.'s creditors and B Co. can defer the payments if it does not meet certain solvency requirements. It is important to consider the characterization of the instrument and tax treatment of the payments thereto under the domestic law of each party's jurisdiction.



Country A and Country B Perspectives: Country B treats the instrument as *debt* and permits the payer, B Co., to deduct the interest payments. Meanwhile Country A treats the instrument as *equity* and exempts the payment as a dividend under its domestic laws. Accordingly, A Co. is not subject to tax on receipt of the payment. Therefore, the transaction results in a D/NI outcome.

OECD's Recommendations: The OECD's recommendations are intended to align the treatment of an MNE's cross-border payments via a hybrid financial instrument such that if the payer's jurisdiction treats the payment as an expense then the payee's jurisdiction recognizes the payment as ordinary income.[28] As the primary recommendation, Country B

should deny B Co. the deduction to the extent the transaction causes a D/NI outcome, i.e., B Co.'s interest payment is denied to the extent A Co. excludes the amount from its income under Country A's laws. As the defensive rule, if Country B does not apply the primary response, then Country A should require A Co. to include the payment in ordinary income.

Example 1.1:[29] Interestingly, the OECD's final report includes an example using the territorial system. The facts are the same as Example 1 above except that Country A follows a territorial tax regime and, therefore, taxes only domestically sourced income. Furthermore, B Co. has no permanent establishment in Country A. A Co. treats the interest income from B Co. (a non-resident) as foreign source income, which is exempt from tax in Country A.

Country A and Country B Perspectives*:* Under the domestic laws of Country A, A Co. excludes the interest from its income and, thus, is not subject to tax on the interest income. B Co. may deduct the interest payment under the domestic laws of Country B. Therefore, the transaction results in a D/NI outcome.

OECD's Recommendation*:* Although the transaction results in a D/NI outcome, the mismatch is *not* derived from the terms of the financial instrument itself but rather the territorial tax regime of Country A—that is, A Co. is exempt from tax on any foreign source income. The parties could not change the terms of the instrument in any way that would make the interest payments taxable in Country A. Thus, the hybrid financial instrument rule applies only if the mismatch results from the terms of the financial instrument itself.

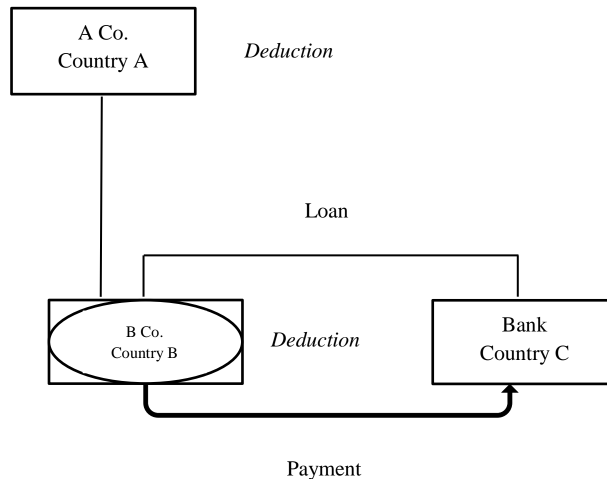
In contrast, in Example 1, Country A (payee jurisdiction) exempts only dividend income. Country A's tax exemption of

the dividends in Example 1 is attributable to both the source of the payments and the terms of the financial instrument. Therefore, the transaction results in a hybrid mismatch.

Hybrid Entities:

Hybrid entities are entities that one country considers non-transparent or opaque for tax purposes while another country treats the same entity as a transparent flow-through or disregarded entity. For example, one country may treat an entity as a C corporation (that is taxed as a separate legal entity) and another country treats the same entity as a partnership (whose partners are generally taxed on their share of the partnership's income subject to certain exceptions). In the following example, an MNE uses a hybrid entity to achieve a favorable DD result.

Example 2:[30] A Co., an entity resident of Country A, owns 100% of B Co., a foreign subsidiary in Country B. B Co. is a hybrid entity—that is, B Co. is treated as a disregarded entity under the laws of Country A and a separate legal entity under the laws of Country B for tax purposes. B Co. borrows money from a local bank and pays interest on the loan.



Country A and Country B Perspectives: Country B views B Co. as a separate legal entity, and, therefore, gives rise to an interest deduction in Country B. Meanwhile, A Country disregards B Co. and treats A Co. as the borrower of the loan permitting A Co. to deduct the interest payment in Country A as well. As a result, the taxpayer achieves a double deduction (i.e., Country A deduction and Country B deduction) for the same interest payment.

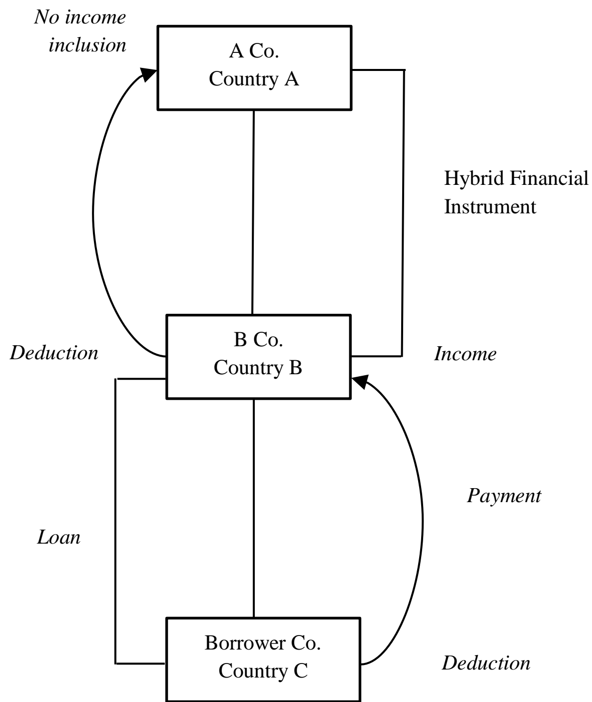
OECD's Recommendations: The OECD recommends a "linking rule" that aligns the tax results in the payer jurisdiction (Country B) with the parent jurisdiction (Country A).[31] The OECD's primary recommendation is for the parent jurisdiction (Country A) to deny the duplicate deduction to the extent the payment gives rise to a DD outcome. As the defensive rule, if the parent jurisdiction (Country A) does not apply the primary response, then the OECD recommends the payer jurisdiction

(Country B) deny the deduction to the extent the payment gives rise to a DD outcome. The defensive rule applies only if the parties to the mismatch are in the same control group or structured arrangement in which the taxpayer is party to that structured arrangement. Moreover, no mismatch arises to the extent the deduction offsets dual inclusion income. [32]

Imported Mismatch Arrangements:

After a taxpayer engages in a hybrid mismatch arrangement between two countries, the taxpayer may shift or import the tax benefit of that offshore hybrid mismatch into a third country via a financial instrument (e.g., an ordinary loan).[33] Imported mismatch arrangements rely on the void of effective hybrid mismatch rules in offshore jurisdictions to achieve the mismatch in tax results, which the taxpayer can then import into the payer jurisdiction. In the following example, an MNE uses an imported mismatch arrangement to achieve a favorable D/NI result.

Example 3:[34] A Co., an entity resident of Country A, owns 100% of B Co., an entity resident of Country B. A Co.'s business is to lend money to medium-sized enterprises. In a back-to-back financing arrangement, A Co. lends money to B Co. via a hybrid financial instrument, and B Co. then lends the same money to C Co., an entity resident of Country C. C Co. is sufficiently involved in the arrangement's design to understand its mechanics and anticipated tax results. Country A treats the hybrid financial instrument as *equity* and exempts the interest payment from B Co. as a dividend under its domestic laws. Country B treats the hybrid financial instrument as debt (to A Co.) and has not implemented hybrid mismatch rules under its domestic laws. C Co.'s financial instrument in Country C is an ordinary loan (from B Co.).



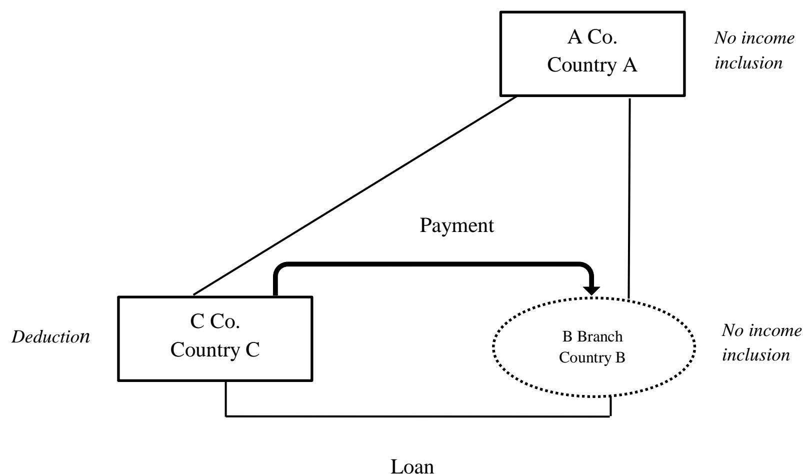
Country A, Country B, and Country C Perspectives: Country A exempts the interest payment from B Co. to A Co. from tax under Country A's domestic law, while B Co. deducts its interest payment to A Co. on its Country B tax return under Country B's laws. C Co. deducts its interest payment to B Co. on its Country C tax return under Country C's laws, while B Co. includes the receipt of the interest on its Country B tax return. As a result of this structure, the taxpayer achieves a favorable indirect D/NI outcome between Country A and Country C. In Country B, B Co.'s interest payment to A Co. should offset the interest income from C Co.

OECD's Recommendations*:* The OECD recommends a "linking rule" as its primary recommendation, which requires the payer jurisdiction to deny the deduction for the payment to the extent the payment generates an indirect D/NI tax result. In other words, the payer jurisdiction (Country C) should deny a deduction for payment to the extent the payee (B Co.) treats such payment as an offset against a hybrid deduction (B Co.'s interest payment to A Co.) in the payee jurisdiction (Country B).[35] Thus, if the primary response is implemented, then C Co.'s deduction is disallowed, B Co.'s receipt of interest income from C Co. is offset against B Co.'s interest payment to A Co., and A Co. recognizes no income on the interest received from B Co. There is no defensive rule for the imported mismatch arrangement.

Branch Mismatch Structures:

A mismatch can occur when one entity makes a deductible payment to a branch and the taxpayer's residence jurisdiction treats the payment as income received by its foreign branch, and, therefore, exempt from income tax under domestic law. Likewise, the branch's jurisdiction disregards the branch, and, thus, does not subject the income to tax. In other words, neither the residence jurisdiction nor the branch jurisdiction includes the payment in ordinary income. In the following example, an MNE uses a disregarded branch structure to achieve a favorable D/NI result.

Example 4:[36] A Co., an entity resident of Country A, has a branch in Country B (B Branch). A Co. lends money to C Co., a related company of A Co. and an entity resident of Country C, through B Branch. C Co. pays interest to B Branch on the loan.



Country A, Country B, and Country C Perspectives: C Co. deducts the interest payment under Country C's domestic laws. A Co. excludes the interest payment because the payment is attributable to a foreign branch (B Branch) under Country A's domestic laws. Moreover, Country B does not tax the interest income because A Co. does not have sufficient presence in Country B under that jurisdiction's domestic laws. Therefore, the structure gives rise to an intra-group mismatch that achieves a D/NI outcome.

OECD's Recommendations: The OECD recommends for a disregarded branch structure that the payer jurisdiction (Country C) deny C Co.'s deduction for a payment that gives rise to a D/NI outcome to the extent that the mismatch is a result of a payment to a disregarded branch (B Branch). Therefore, C Co. cannot deduct its interest payment to B Branch.[37]

IV. TAX POLICY

Hybrid mismatch arrangements raise several policy concerns that can impact tax revenue, competition, fairness, economic efficiency and transparency.[38] Although taxpayers incur initial costs for advice and implementation of hybrid mismatch arrangements, these arrangements can lead to significant tax savings—that is, MNEs have the potential to reduce the overall tax burden for the parties involved. Consequently, the tax authorities are unable to collect as much tax revenue and collectively lose revenue in the process. The tax advantages that these structures create may also provide MNEs with a competitive advantage in comparison to small or mid-sized companies, which cannot easily expend the cost for tax advice nor implement mismatch arrangements.[39] MNEs may have access to tax planning experts or strategies (which reduce their tax liabilities) but are cost prohibitive to smaller businesses, which some argue is inherently unfair.[40]

Hybrid mismatch arrangements can affect economic efficiency, i.e., investors may find cross-border investment more attractive in locales conducive to hybrid mismatches than an equal domestic investment.[41] Furthermore, hybrid mismatch arrangements may add to financial instability by increases in tax-favored leveraging or borrowing and a rise in risk-taking because investments that were uneconomic before tax may become practicable after tax. These tax-driven arrangements may also affect transparency if the public does not fully grasp the underlying cause of a taxpayer's low effective tax rate.[42]

The tax policy behind the BEPS project centers on the single tax principle, which provides that all income should be taxed only once.[43] Specifically, the tax rate that applies depends on whether the income is passive or active, i.e., passive income should be taxed at the residence country tax rate and active

income at the average source country tax rate. Thus, the single tax principle requires the removal of not only double taxation, but double **non**-taxation as well (e.g., D/NI, DD transactions).[44] Commentators have remarked that OECD's Action 2 solutions are "soft recommendations" rather than global minimum standards.[45] Consequently, the length of time for countries to converge and adopt these recommendations is unclear and may result in non-coordination and inconsistency. Although a number of countries have displayed their intent to legislatively integrate the OECD's recommendations, other countries may not act as deftly (or if at all) in this regard.[46] The divergent interests of different tax jurisdictions and unilateral action by some countries to protect tax revenue have made it difficult to establish a cohesive set of rules.[47]

To further complicate matters, each country must have a working knowledge of the tax treatment of the hybrid arrangements in other jurisdictions to apply the recommendations.[48] Without cooperation and transparency from the taxpayers themselves to apply these rules under the applicable domestic law of affected countries, government agencies may find it difficult to recognize and determine the tax effects of a hybrid mismatch arrangement (much less enforce the rules under local law). Moreover, taxpayers may find it appealing to restructure or replace existing hybrid mismatch arrangements with other planning opportunities that achieve the same D/NI or DD outcome but are beyond the reach of Action 2's linking rules, e.g., income exempt from tax under a pure territorial regime. Because each country can determine its own domestic laws, countries may continue to vary in their treatment of financial instruments (e.g., debt versus equity) or hybrid entities (e.g., transparent or separate taxable entity).[49] Yet, even worse, countries may engage in a "race to the bottom" that compromises the neutralizing effects of Action 2's recommendations in some tax jurisdictions.[50]

Despite these challenges, the OECD has reported some progress in this area. In particular, the OECD states:

> Although not a minimum standard, Action 2 has been rapidly adopted by a number of members of the OECD/G20 Inclusive Framework. EU Member States adopted hybrid and branch mismatch rules in Council Directive (EU) 2017 ("ATAD 2") and hybrid mismatch rules were also included as part of the US tax reform legislation, which passed into law at the end of last year.[51]

V. U.S. TAX IMPLICATIONS – THE EFFECTS OF THE TAX CUTS AND JOBS ACT

The Tax Cuts and Jobs Act has been touted as the most significant U.S. tax reform since the Tax Reform Act of 1986. As part of the recent tax overhaul, TCJA codified sweeping changes that impact international tax—specifically, tax provisions meant to deter and combat base erosion and profit shifting. TCJA's international tax provisions directly address the factors under prior law (i.e., high corporate tax rate, worldwide tax regime, deferral of overseas profits) that provided incentives for MNEs to engage in tax arbitrage. The TCJA reduced the corporate tax rate and added or modified provisions to limit interest expense deductions, tax unrepatriated earnings, move towards a territorial tax system, and impose a base erosion and anti-abuse tax ("BEAT"). The following discusses key provisions of TCJA that directly impact and may have been implemented to defeat (or at least deter) the effect of hybrid mismatch structures.

Corporate Tax Rate

Prior to TCJA, corporations were subject to a graduated tax rate structure and the top corporate tax rate was generally 35 percent on taxable income in excess of $10 million. Effective for taxable years beginning after December 31, 2017, TCJA provides a flat corporate tax rate of 21 percent.[52] Although the 21% U.S. corporate tax rate is significantly lower than the prior tax of 35%, this rate still exceeds the corporate tax rates of competing jurisdictions such as Ireland's 12.5% tax rate and the United Kingdom's 19% tax rate.[53] Arguably, other countries may respond to the U.S. in kind by competitively reducing their tax rates below the current U.S. corporate tax rate of 21%.[54]

Deemed Repatriation of Accumulated Post-1986 Deferred Foreign Income

The Joint Committee on Taxation estimated for 2015 that U.S. companies accumulated approximately $2.6 trillion of undistributed and previously untaxed foreign earnings offshore.[55] Under prior law, U.S. multinational companies could defer taxation on unrepatriated foreign earnings and profits generally declared as "permanently reinvested" abroad for financial statement purposes. TCJA imposes a one-time tax on these foreign earnings through the mechanism of deemed repatriation, which subjects previously untaxed foreign earnings to immediate taxation under the Subpart F rules.[56] As the U.S. moves towards a quasi-territorial tax system, the deemed repatriation tax is in essence a transition tax on previously unrepatriated foreign earnings. To ensure that all distributions from foreign subsidiaries are treated in the same manner under the quasi-territorial tax system (participation exemption system),[57] unrepatriated earnings must be taxed as if the earnings are repatriated subject to a reduced tax rate. The provision is effective for the last tax year of a foreign corporation that begins

before January 1, 2018, and with respect to U.S. shareholders, for the tax years in which or with which such foreign corporations' tax years end.

In general, the repatriation tax applies not only to controlled foreign corporations, but also foreign corporations in which a U.S. person owns a 10-percent voting interest.[58] A U.S. shareholder is required to include its pro rata share of certain foreign subsidiaries' post-1986 accumulated deferred foreign earnings and profits.[59] Pursuant to I.R.C. Section 965, the foreign corporation's Subpart F income is increased by the greater of accumulated post-1986 deferred foreign earnings determined as of November 9, 2017 or December 31, 2017[60] and the U.S. shareholder must include this amount in its gross income.[61] The inclusion, however, is reduced by the U.S. shareholder's pro rata share of deficits from certain foreign subsidiaries.[62] Moreover, the U.S. shareholder may deduct a portion of the income inclusion in a manner such that the deduction results in a reduced tax rate on the inclusion of previously untaxed foreign earnings.[63] The amount of the deduction depends on whether the deferred earnings are held in cash or other assets—that is, the U.S. shareholder may deduct from the inclusion the amount necessary to obtain a 15.5 percent effective tax rate on deferred foreign earnings held in cash (or cash equivalents) and an 8 percent effective tax rate on all other earnings (i.e., illiquid assets).[64] Furthermore, the U.S. shareholder may offset the tax with foreign tax credits subject to limitations, i.e., foreign tax credits are limited to the taxable portion of the inclusion.[65] The domestic corporation generally may elect to pay the tax liability over an eight-year period.[66]

Lastly, if a U.S. shareholder expatriates[67] within 10 years of TCJA's enactment on December 22, 2017 (i.e., 12/22/27), then the formerly domestic corporation is subject to recapture of the deduction.[68] Indeed, the expatriated entity[69] is denied any

deduction on the inclusion and the entire inclusion is taxed at 35 percent.

Interest Expense Limitation

Earnings stripping occurs when a corporation pays interest to a related party and the related party is not (or is only minimally) subject to U.S. tax on the corresponding interest income. Effective for tax years beginning after December 31, 2017, TCJA modified the earnings stripping provision under I.R.C. Section 163(j) by limiting the business interest deduction to the sum of the following for the taxable year:[70] (1) business interest income,[71] (2) 30 percent of the taxpayer's adjusted taxable income ("ATI") but not below zero, and (3) the taxpayer's floor plan financing interest.[72] ATI is defined as taxable income calculated without the following: (1) any item of income, gain, deduction or loss that is not properly allocable to a trade or business; (2) any business interest expense or business interest income; (3) any net operating loss deduction; (4) deductions for qualified business income under I.R.C. § 199A; and (5) for taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization or depletion.[73] In other words, ATI is approximately equal to earnings before interest, taxes, depreciation and amortization for tax years after December 31, 2017 and before January 1, 2022. For tax years after December 31, 2021, ATI then approximately equals earnings before interest and taxes. Furthermore, the taxpayer may carryforward any disallowed business interest deductions indefinitely subject to certain restrictions.[74]

Example 5: For the taxable year ended December 31, 2018, A Corporation has business interest income of $1,000, ATI of $20,000 and no floor plan financing interest. A Corporation pays $10,000 of business interest expense. A Corporation's deduction for business interest is limited to

$7,000 [$1,000 + (30% x $20,000)] and the remaining $3,000 of disallowed interest is carried forward indefinitely.

Pursuant to an exception for small businesses, taxpayers with average annual gross receipts for the three-taxable-year period ending with the prior taxable year that do not exceed $25 million are exempt from the interest expense limitation.[75] Moreover, I.R.C. Section 163(j) does not apply to regulated public utilities, certain real estate industries (by taxpayer's election), electric cooperatives, the trade or business of performing services as an employee and farming businesses (by taxpayer's election).[76]

Participation Exemption System (a Quasi-territorial Tax System)

As discussed in Part II, countries that follow a territorial tax system impose tax only on income that is sourced within the specific country's borders. TCJA includes provisions that move the U.S. from a worldwide tax system toward a quasi-territorial tax regime under I.R.C. Section 245A. Effective for distributions made after December 31, 2017, a U.S. *corporation* that owns at least 10% stock of foreign corporations[77] may deduct 100 percent of the foreign-source portion of the dividends that it receives from these foreign corporations.[78] Notably, this provision does not apply to non-corporate U.S. shareholders (e.g., individuals). Furthermore, this dividend deduction applies only to income of foreign corporations and not to income of branches. I.R.C. Section 245A effectively exempts certain foreign source income through this 100-percent dividends-received deduction ("DRD") even if there is no withholding tax on the dividend at source and the foreign subsidiary paid the dividend from earnings that were not subject to foreign tax in its country of incorporation. The foreign-source portion of the dividend is the amount that bears the same

ratio to the dividend as the undistributed foreign earnings[79] bears to the foreign corporation's[80] total undistributed earnings and profits.[81] Furthermore, the Internal Revenue Code disallows a foreign tax credit or deduction for paid or accrued taxes attributable to the portion of a distribution that qualifies for the DRD.[82]

To qualify for the DRD, the U.S. corporation must satisfy a holding period requirement, i.e., the domestic corporation must hold the stock of the specified 10%-owned foreign corporation for more than 365 days during the 731-day period beginning on the date that is 365 days before the date on which the share becomes ex-dividend with respect to the dividend.[83] In essence, the U.S. has eliminated U.S. tax on repatriated foreign earnings in an effort to disincentivize U.S. multinationals from keeping their earnings offshore.

Hybrid Dividends:

I.R.C. Section 245A squarely addresses hybrid mismatch arrangements, which take advantage of the different tax treatments under U.S. and foreign laws of certain payments (e.g., hybrid financial instrument, hybrid entities) that produce D/NI or DD outcomes.[84] The purpose of the provision is to deter the benefits of such tax arbitrage and it follows generally (but does not codify all) the OECD's Action 2 recommendations for hybrid financial instruments.[85] In accordance with the single tax principle, a U.S. shareholder is disallowed from claiming the 100-percent DRD for any dividend from a controlled foreign corporation ("CFC") that is a hybrid dividend.[86]

As illustrated in the examples in Part III, a hybrid dividend results when a CFC distributes a dividend to a U.S. shareholder and both the foreign corporation and the U.S. shareholder can deduct the dividend under each entity's

respective tax jurisdictions—that is, the foreign corporation (payor) may claim a deduction (or other tax benefit) for the dividend in its country and the U.S. shareholder (payee) may also deduct the dividend in the U.S. under the general rule of I.R.C. Section 245A.[87] The U.S. shareholder, however, is denied the DRD, and thus, the double deduction that taxpayers may otherwise claim is prevented.[88] Moreover, if a controlled foreign corporation distributes a hybrid dividend to another recipient-controlled foreign corporation, then the latter treats the hybrid dividend as Subpart F income. Accordingly, its U.S. shareholder must include the shareholder's pro rata share in gross income.[89] Lastly, the U.S. shareholder cannot claim foreign tax credits or deductions for any taxes paid or accrued with respect to the hybrid dividend.[90] Under these circumstances, the provision effectively blocks the U.S. shareholder (payee) from the benefits of a tax-free repatriation of foreign income.

Base Erosion Anti-avoidance Tax
Cross-border Payments between Affiliated Companies:

In an effort to target base erosion and profit shifting, I.R.C. Section 59A (as added by TCJA) provides the base erosion anti-avoidance tax ("BEAT"). These provisions are meant to deter base erosion via deductible cross-border payments between affiliated companies (i.e., foreign parents or controlled foreign corporations).[91] Simply put, BEAT's purpose is to deter earnings stripping transactions, which multinational entities have used to shift profits to lower tax jurisdictions through intercompany transfers. BEAT appears to take particular aim at U.S. subsidiaries of foreign parents that shift profits outside of the U.S. through outbound payments.

In essence, BEAT is an alternative minimum tax, which an MNE must pay if it reduces its regular U.S. tax liability below

the applicable percentage of its modified taxable income for this purpose. BEAT applies to U.S.-owned and foreign-owned multinational corporations and casts its net on payments to foreign parents and foreign subsidiaries.[92] Consistent with the single tax principle, if the income is not subject to tax at residence, then BEAT imposes tax at the source of the income.[93]

Effective for base erosion payments paid or accrued in taxable years beginning after December 31, 2017, a taxpayer must pay a "base erosion minimum tax"[94] if (1) the taxpayer is a corporation (other than a regulated investment company, a real estate investment trust, or an S corporation) with average annual gross receipts of at least $500 million for the three-year taxable year period ending with the preceding tax year and (2) the corporation's base erosion percentage for the tax year is 3 percent[95] or greater.[96] The base erosion percentage is determined by dividing the taxpayer's aggregate base erosion tax benefits (generally, any deduction from certain base erosion payments to a foreign related party)[97] by the taxpayer's aggregate deductions allowed [tax-deductible expenses], taking into account base erosion tax benefits subject to certain exceptions.[98] A base erosion payment is (1) any deductible amount that a taxpayer paid or accrued to a foreign related party[99] (e.g., interest payment to foreign parent, royalty payment to foreign subsidiary), (2) paid or accrued to a foreign related party to acquire property that is subject to depreciation or amortization, (3) certain reinsurance payments to a foreign related party, or (4) certain payments with respect to a surrogate foreign corporation or related foreign persons that results in a reduction of the taxpayer's gross receipts.[100] Therefore, BEAT may significantly impact companies that depend on cross-border transactions (e.g., professional service, banks, insurance companies).

The tax is equal to the excess of the applicable rate (5% for taxable year beginning in 2018, 10% for tax year beginning in 2019 through 2025, and 12.5% for tax year beginning after December 31, 2025)[101] of the taxpayer's modified taxable income over its regular tax liability reduced by certain tax credits (but not below zero).[102] For this purpose, the modified taxable income is generally equal to taxable income without any base erosion tax benefit or base erosion percentage from a net operating loss deduction.[103] In other words, the taxpayer adds back to its taxable income any base erosion tax benefit and base erosion percentage from a net operating loss deduction. The taxpayer must compare taxes calculated under BEAT to its regular tax liability and, consequently, pay the higher levy. Notably, BEAT applies only to payments made to related parties, and thus, taxpayers may avoid BEAT altogether by transacting with customers or unrelated distributors.[104]

Hybrid Transactions or Hybrid Entities:

As discussed in Part III, a hybrid transaction is any transaction, series of transactions, agreement, or instrument where the payer's tax jurisdiction treats the payment(s) as deductible interest or royalties (e.g., U.S. federal income tax) while the payee recipient's jurisdiction does not. The difference in treatment between the jurisdictions results in a D/NI (deduction with no corresponding income inclusion) or DD (double deduction) mismatch to the taxpayer's benefit. A hybrid entity is considered fiscally transparent (e.g., partnership) for U.S. federal income tax purposes while another tax jurisdiction considers the same entity as non-transparent or opaque (e.g., C corporation) for tax purposes. In contrast, a reverse hybrid entity is considered non-transparent or opaque for U.S. tax purposes while another tax jurisdiction considers the same entity fiscally transparent.

Consistent with the OECD's BEPS Action 2 initiative and the single tax principle, I.R.C. Section 267A denies a deduction for payments to a related party pursuant to a hybrid transaction or hybrid entity if (1) there is no corresponding inclusion to the related party under its tax jurisdiction (D/NI) or (2) the related party is also allowed a deduction under its tax jurisdiction (DD). I.R.C. Section 267A is effective for tax years beginning after December 31, 2017.

Proposals for Reform

Practitioners and commentators have raised their concerns about the recent legislation, and in particular, technical and policy issues of the provisions involving hybrid arrangements. Overall, the consensus appears to be that the U.S. is moving in the right direction toward international tax reform, but there is still much work left to be done. The following discusses key issues and proposals for reform (through legislation or regulation) debated by commentators.

Deemed Repatriation Tax:

Deemed repatriation rules under I.R.C. Section 965 impose an immediate tax on previously untaxed foreign earnings at rates of 15.5% on cash and cash equivalents (i.e., liquid assets) held abroad and 8% on all other unrepatriated earnings (i.e., illiquid assets). Commentators have expressed a number of concerns about the technical aspects of this provision. First, cash equivalent as defined for this purpose appears overly broad. The definition of cash includes financial instruments, e.g., options contracts, futures contracts and bona-fide hedging transactions, that if held overseas are subject to a tax rate of 15.5% under these rules.[105] Commentators have argued that this treatment could be over-inclusive because some of these financial instruments may be illiquid or may have a non-tax

avoidance business purpose.[106] The Secretary is authorized to issue regulations or other guidance that may be necessary or appropriate to carry out the provisions of I.R.C. Section 965.[107] Accordingly, Treasury should provide regulatory guidance that clarifies the term cash and cash equivalents for this purpose.

Second, downward attribution rules (meant to limit corporate inversions) apply under I.R.C. Section 965 for purposes of determining the U.S. ownership of a foreign corporation. In other words, stock owned by a foreign corporation is attributed to a U.S. person for purposes of establishing a controlled foreign corporation. As a result, the amount of taxpayers defined as a U.S. shareholder in a CFC may increase and cause a higher inclusion of income subject to the deemed repatriation tax.[108] To prevent this over inclusion, Congress should consider limiting the downward attribution rules only to corporations.[109]

Third, the deemed repatriation tax is calculated using the higher measured base of two testing dates, i.e., November 2, 2017 and December 31, 2017. Commentators have raised a potential loophole related to the testing dates for taxpayers with fiscal year ends (rather than calendar year ends). Taxpayers with fiscal year ends (e.g., 6/30, 9/30) could potentially avoid additional cash accumulations (subject to the deemed repatriation tax) by distributing any increase as dividends.[110] To address this potential loophole, Treasury should provide guidance that considers the facts and circumstances of a taxpayer's cash movements and investments.[111]

Lastly, if history repeats itself, MNEs during the 2004 tax holiday used repatriated earnings to distribute dividends to or buyback stock from their shareholders rather than create new jobs nor invest in capital spending or expansion.[112] Although MNEs repatriated offshore earnings because of the transition

tax, a significant amount of the repatriated earnings was invested in stock buybacks.[113]

Interest Expense Limitation:

The interest expense limitation is directed at MNEs that use interest expense deductions to strip earnings out of higher-tax jurisdictions. Commentators have raised concerns over various methods taxpayers could use to avoid the limitation. For example, financial institutions with positive net interest can lease assets and deduct the rental payments on those leases.[114] Taxpayers could also opt to incur debt outside of the U.S. or to issue preferred equity.[115] The House and Senate bills included a provision specifically directed at profit shifting by restricting the U.S. entity's share of debt based on its income or assets; however, the provision was removed from the final legislation. To prevent taxpayers from circumventing the interest expense limitation, Congress should consider using a worldwide interest allocation that allows a U.S. company to deduct only its allocable share of interest expense based on its share of worldwide income.[116]

BEAT :

The primary purpose of BEAT is to deter earnings stripping transactions, which MNEs have used to shift profits to lower tax jurisdictions through intercompany payments between affiliated companies. Although BEAT appears to strengthen U.S. taxation of inbound transactions, commentators have argued over a number of issues that may impact the intended effect of the tax. First, commentators have asserted that the $500 million revenue threshold that triggers BEAT is too high, i.e., the amount is 10 times the threshold under I.R.C. Section 385 directed at earnings stripping. Because of the high threshold, many MNEs below this threshold that engage in profit shifting

transactions (otherwise subject to BEAT) are able to avoid the tax.[117] Moreover, BEAT does not apply unless the base erosion payments are above the specified threshold, which is generally 3%.

Both thresholds create a "cliff effect" and may encourage MNEs to plan their structures or transactions in a manner such that they fall right below the required thresholds to escape BEAT entirely—that is, $499 million in average annual gross receipts and/or a base erosion percentage of 2.99%.[118] Nonetheless, even when BEAT does apply, the nominal tax rate of 10% appears hardly sufficient to deter profit shifting.[119] To address these issues, Congress should consider the following: significantly reduce BEAT's $500 million revenue threshold and add an asset test similar to the thresholds under I.R.C Section 385's earnings stripping regulations; remove the base erosion percentage threshold of 3% altogether; and increase the BEAT rate of 10% to a tax rate that would more likely deter profit shifting. Perhaps Congress should simply restrict BEAT to outbound payments made to no or low tax jurisdictions.[120]

Second, base erosion payments, as defined, generally exclude payments for cost of goods sold (except for inverted corporations after November 9, 2017). As a result, taxpayers could exploit planning opportunities that avoid BEAT altogether such as capitalizing royalty payments into cost of goods sold, embedding foreign intellectual property into a product's cost of goods sold, or restructuring the supply chain.[121] For example, a U.S. subsidiary pays a foreign parent for tangible property and includes the goods in its inventory for sale. The U.S. subsidiary also pays a royalty to the foreign parent for the trademark or distribution rights of these goods. Because the royalty payments are capitalized as part of cost of goods sold, the U.S. subsidiary is able to elude BEAT on these royalty payments.[122] To prevent this loophole, commentators have suggested that base erosion

payments include payments for goods, but the taxpayer should be permitted to claim a cost component deduction (which would address the royalty payments concern).[123] However, there is no clear answer to this issue because a tax on cross-border sales of inventory could prove problematic with the World Trade Organization and, consequently, result in trade and treaty issues.[124]

Third, certain services with no mark-up (i.e., services using the service cost method) are excluded from base erosion payments. Commentators and practitioners disagree over the treatment of the cost component of services *with* a markup—that is, some argue that any service with a markup is included for BEAT purposes in total while others argue that only the markup is included.[125] Proposed Treasury Regulations clarify whether taxpayers may exclude any portion of the services with a markup from BEAT—that is, taxpayers may use the service cost method exception if there is a markup, but the portion of any payment that exceeds the total cost of services (the markup component) is ineligible for this exception and consequently a base erosion payment.[126]

Fourth, BEAT does not provide a credit for foreign taxes and, therefore, may function more as a tax on foreign source income rather than serve its intended purpose to limit profit shifting. For example, a multinational with substantial foreign source income from high tax jurisdictions makes the minimum base erosion payments subject to BEAT. Because there is no foreign tax credit for BEAT, it acts as a tax on foreign source income in this scenario instead of serving its intended purpose, which is to restrict the effects of profit shifting.[127] Accordingly, Congress should consider allowing a foreign tax credit for BEAT.[128]

Fifth, commentators expressed various other concerns including whether taxpayers must aggregate individual payments for BEAT purposes (e.g., if interest payments are assessed at a gross or net basis); BEAT is over-inclusive in certain circumstances (e.g., applies to ordinary transactions, nonabusive commercial transactions, and securities lending); BEAT may penalize routine lending transactions between groups; and BEAT may impact intragroup interest payments made by regulated financial intermediaries (e.g., banks, securities dealers).[129] To address these concerns, Congress should reconsider using a worldwide allocation of interest that allows a U.S. company to deduct only its allocable share of interest expense based on its share of worldwide income or assets.[130]

Finally, because the anti-hybrid provisions limit interest and royalty payments between related parties, MNEs may find ways to deduct other types of payments to create D/NI or DD outcomes.[131] In addition, a number of issues remain unresolved in this area, e.g., the treatment of conduit arrangements and multiple country arrangements, which may impact the effectiveness of the anti-hybrid provisions.[132] Treasury should provide guidance that addresses these remaining concerns.

VI. CONCLUSION

MNEs have used hybrid mismatch arrangements to produce favorable tax outcomes (D/NI or DD) that erode its tax bases in applicable jurisdictions through double non-taxation or tax deferral resulting in significant tax savings. In 2015, the OECD issued its final reports on the 15 Action Items included in its Base Erosion Profit Shifting Plan—specifically, Action 2 provides recommendations under domestic law to neutralize the

effects of hybrid mismatch arrangements. In an effort to defeat these transactions, the U.S. has codified key provisions in recent legislation that generally follow the OECD's recommendations and directly address in TCJA's anti-hybrid provisions the impact of hybrid mismatch arrangements. However, multilateral efforts are needed to deter hybrid mismatch arrangements and coherently dismantle the benefits of base erosion and profit shifting. Moreover, there is a risk that TCJA's recent provisions may be changed in the future, and as in any match, only time will tell if these provisions produce the results intended or if these transactions continue off the BEATen path as the "perfect mismatch."

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[1] Match Group, Inc., Annual Report (Form 10-K), at 3 (Dec. 31, 2017). Match Group, Inc. operates a portfolio of online dating brands including Match, Tinder, PlentyOfFish, Meetic, OkCupid, OurTime, and Pairs. *Id.*

[2] *Id.* at 4-5.

[3] *Id.* at 31 & 57.

[4] Tax Cuts and Jobs Act of 2017, Pub. L. 115-97, 131 Stat. 2054 (2017).

[5] Source refers to the country in which a taxpayer's income and expenses are allocated. I.R.C. §§ 861, 865.

[6] I.R.C. §§ 901, 904.

[7] *See* I.R.C. §§ 951–65.

[8] *See* I.R.C. §§ 954–64. The Subpart F provisions require U.S. shareholders of "controlled foreign corporations" ("CFC") to recognize their pro rata share of and pay U.S. tax on certain CFC income. In general, a CFC is a foreign corporation owned by U.S. shareholders who own more than 50% of the vote or value of the CFC's outstanding shares. I.R.C. § 951(b).

[9] *See* I.R.C. §§ 1291–98, which impose current tax on U.S. shareholders of foreign investment companies.

[10] Prior to the TCJA, the U.S. corporate tax rate could reach up to 35%.

[11] For example, a foreign corporation may be subject to U.S. tax only on income from business operations that the foreign corporation conducted through a "permanent establishment" in the U.S.

[12] *See* Part V, *infra* (U.S. Tax Implications – The Effects of the Tax Cuts and Jobs Act).

[13] OECD, *Hybrid Mismatch Arrangements: Tax Policy and Compliance Issues* (May 3, 2012), http://www.oecd.org/ctp/exchange-of-tax-information/hybridmismatcharrangementstaxpolicyandcompliaanceissues.htm [hereinafter OECD, *Hybrid Mismatch*].

[14] Reuven S. Avi-Yonah & Haiyan Xu, *Evaluating BEPS: A Reconsideration of the Benefits Principle and Proposal for UN Oversight*, 6 HARV. BUS. L. REV. 185 (2016), at 209, http://www.hblr.org/wp-content/uploads/2017/01/1.-Evaluating-BEPS.pdf.

[15] Joint Committee on Taxation, *Background, Summary, and Implications of the OECD/G20 Base Erosion and Profit Shifting Project*, JCX-139-15, Nov. 30, 2015 [hereinafter JCX-139-15].

[16] *Id.* at 9.

[17] OECD, *Hybrid Mismatch*, *supra* note 13, at 5.

[18] The OECD is a forum where governments across the globe work together to contend with economic, social and environmental challenges of globalization. *See* OECD, *Hybrid Mismatch, supra* note 13. The OECD has also provided a setting where governments can work to coordinate domestic and international policies. For example, the OECD has worked to develop normative tax principles that resolve conflicts over multi-jurisdictional claims to tax cross-border income. *See* JCX-139-15, *supra* note 15. The OECD includes the following member countries: Australia, Austria, Belgium, Canada, Chile,

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the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, the Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. (JCX-139-15, *supra* note 15, at 4-5)

[19]The G20 is a forum for international economic cooperation, which includes the following member countries and the European Union: Argentina, Australia, Brazil, Canada, China, France, the European Union, Germany, India, Indonesia, Italy, Japan, the Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, and the United States. (JCX-139-15, *supra* note 15, at 7)

[20] OECD, *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 – 2015 Final Report* (Oct. 5, 2015), http://www.oecd.org/ctp/neutralising-the-effects-of-hybrid-mismatch-arrangements-action-2-2015-final-report-9789264241138-en.htm [hereinafter OECD, *Final Report*].

[21] See OECD, *Hybrid Mismatch*, *supra* note 13.

[22] *Id.* at 7.

[23] Itai Grinberg, *The New International Tax Diplomacy*, 104 GEO. L.J. 1137 (2016), at 1174.

[24] OECD, *Final* Report, *supra* note 20; *see also* OECD, *Public Discussion Draft BEPS Action 2: Neutralise the Effects of Hybrid Mismatch Arrangements (Recommendations for Domestic Laws)* (2014), https://www.oecd.org/ctp/aggressive/hybrid-mismatch-arrangements-discussion-draft-domestic-laws-recommendations-march-2014.pdf.

[25] OECD, *Final* Report, *supra* note 20.

[26] For a detailed discussion of complex hybrid mismatch arrangements, see OECD, *Final* Report, *supra* note 20.

[27] OECD, *Final* Report, *supra* note 20, at 175, Ex. 1.1.

[28] OECD, *Final* Report, *supra* note 20, at 18.

[29] *Id.* at 195, Ex. 1.7.

[30] *Id*. at 326, Ex. 6.4.
[31] *Id*. at 17, 67, 69.
[32] Dual inclusion income is defined as "income brought into account for tax purposes
under the laws of both jurisdictions." *Id*. at 69. An item of income will be dual inclusion income "if the same item is included in income under the laws of the jurisdictions where the DD outcome arises." *Id*. at 71.
[33] *Id*. at 83.
[34] *Id*. at 443, Ex. 10.5.
[35] *Id*. at 83, 85.
[36] OECD, *Neutralising the Effects of Branch Mismatch Arrangements, Action 2* (July 27, 2017), http://www.oecd.org/tax/beps/neutralising-the-effects-of-branch-mismatch-arrangements-action-2-9789264278790-en.htm.
[37] *Id.* at 27, 28.
[38] OECD, *Hybrid Mismatch*, *supra* note 13, at 11.
[39] *Id.*
[40] *Id*. at 12.
[41] *Id.*
[42] *Id.* at 11–12.
[43] Grinberg, *supra* note 23, at 17.
[44] Avi-Yonah & Xu, *Evaluating BEPS*, *supra* note 14, at 23.
[45] *Id.* at 31.
[46] Mindy Herzfeld, *The Case Against BEPS – Lessons for Coordination*, 21 FLA. TAX REV. 1 (2017), at 7, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2985752. *But see* Part V, *infra* (U.S. Tax Implications – The Effects of the Tax Cuts and Jobs Act).
[47] Herzfeld, *supra* note 46, at 23, 32.
[48] Brett Wells, *Get with the BEAT*, TAX NOTES (Feb. 15, 2016), at 798-99.
[49] Avi-Yonah & Xu, *Evaluating BEPS*, *supra* note 14, at 31.
[50] *Id*.

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[51] OECD, *OECD/G20 Inclusive Framework on BEPS: Progress Report July 2017-June 2018* (2018), at 26, http://www.oecd.org/tax/beps/inclusive-framework-on-beps-progress-report-july-2017-june-2018.pdf.
[52] I.R.C. § 11(b). *See* I.R.C. § 15(a) and Notice 2018-38, 2018-18 I.R.B. 38, which provides guidance for corporations whose fiscal tax year started before January 1, 2018 but ended after December 31, 2017.
[53] *See* KPMG CORPORATE TAX RATES TABLE, *at* https://home.kpmg.com/xx/en/home/services/tax/tax-tools-and-resources/tax-rates-online/corporate-tax-rates-table.html (last visited January 2, 2019).
[54] David Kamin *et al.*, *The Games They Will Play: Tax Games, Roadblocks, and Glitches Under the 2017 Tax Legislation*, 103 MINN. L. REV. (forthcoming), at 61–62, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3089423## .
[55] Joint Committee on Taxation, *Letter to U.S. House of Representatives*, Aug. 31, 2016, https://waysandmeans.house.gov/wp-content/uploads/2016/09/20160831-Barthold-Letter-to-BradyNeal.pdf.
[56] *See* Part II, *supra* (Tax Regimes).
[57] *See* Part V, *supra* (Participation Exemption System (a Quasi-territorial Tax System)).
[58] I.R.C. § 965(e)(1), which defines a "specified foreign corporation."
[59] As defined in I.R.C. § 965(d)(2).
[60] I.R.C. § 965(a). *See* Joint Committee on Taxation, *General Explanation of Public Law 115-97*, JCS-1-18, Dec. 20, 2018 [hereinafter JCS-1-18], at 355-368.
[61] I.R.C. §§ 951(a), 965(f)(1). The E&P measurement dates are defined as November 2, 2017, and December 31, 2017, collectively, and each an E&P measurement date. Prop. Treas. Reg. § 1.965-1(f)(23). The final cash measurement date of a

specified foreign corporation is the close of the last taxable year of the specified foreign corporation that begins before January 1, 2018, and ends on or after November 2, 2017. Prop. Treas. Reg. § 1.965-1(f)(24). According to the preamble of the proposed regulations, "[t]he choice of a November 2, 2017, measurement date reflects an intent to impose a transition tax on a snapshot of earnings as of a date that coincides with the introduction of the Act in Congress, and reflects a general policy of disregarding taxpayer actions occurring after November 2, 2017, that reduce the taxpayer's liability imposed by reason of section 965..."

[62] I.R.C. § 965(b)(2).

[63] I.R.C. § 965(c).

[64] I.R.C. § 965(c). *See* Prop. Treas. Reg. § 1.965-1, REG-104226-18 (Aug. 1, 2018) for guidance on how to apply particular mechanical rules; Notice 2018-7, 2018-4 I.R.B. 317; Notice 2018-13, 2018-6 I.R.B. 341 and Notice 2018-26, 2018-16 I.R.B. 480; *see also* IRS Publication 5292: How to Calculate Code Sec. 965 Amounts and Elections Available to Taxpayers (Apr. 6, 2018), https://www.irs.gov/pub/irs-pdf/p5292.pdf.

[65] I.R.C. § 965(g).

[66] I.R.C. § 965(h)(1).

[67] *See* I.R.C. § 7874(a)(2).

[68] I.R.C. § 965(l)(1).

[69] I.R.C. § 965(l)(2).

[70] I.R.C. § 163(j)(1). *See* JCS-1-18, *supra* note 60, at 173-179; Prop. Treas. Reg. § 1.163(j)-1 *et seq.*, REG-106089-18 (Nov. 26, 2018) for specific guidance on how to determine the amount of deductible business interest expense.

[71] As defined in I.R.C. § 163(j)(6).

[72] I.R.C. § 163(j)(9)(A). Floor plan financing indebtedness is defined as "indebtedness used to finance the acquisition of motor vehicles for sale or lease" to retail customers and secured by the inventory so acquired. I.R.C. § 163(j)(9)(B).

[73] I.R.C. § 163(j)(8).

[74] I.R.C. § 163(j)(2).
[75] I.R.C. § 163(j)(3).
[76] I.R.C. § 163(j)(7).
[77] A "specified 10-percent owned foreign corporation" is defined as any foreign corporation (other than a passive foreign investment company that is not also a controlled foreign corporation) to which any domestic corporation is a U.S. shareholder. I.R.C. § 245A(b).
[78] I.R.C. § 245A(a). *See* JCS-1-18, *supra* note 60, at 348-351. Notably, portfolio U.S. investors are still subject to tax on foreign source dividends. Furthermore, if a U.S. parent corporation makes a dividend distribution to its taxable U.S. shareholders, the distribution is subject to tax at the capital gains rate.
[79] Undistributed foreign earnings include only the portion of undistributed earnings that is neither attributable to effectively connected income [I.R.C. § 245(a)(5)(A)] nor dividends from an 80-percent owned domestic corporation [I.R.C. § 245(a)(5)(B)]. I.R.C. § 245A(c)(3).
[80] I.R.C. § 245A(c)(1).
[81] I.R.C. § 245A(c)(2).
[82] I.R.C. § 245A(d).
[83] I.R.C. § 246(c)(5); H.R REP. NO. 115-466, at 600 (2017) (Conf. Rep.).
[84] I.R.C. § 245A(e)(1).
[85] OECD, *Final Report*, *supra* note 20.
[86] I.R.C. § 245A(e)(1).
[87] I.R.C. § 245A(e)(4).
[88] I.R.C. § 245A(e)(1).
[89] I.R.C. § 245A(e)(2).
[90] I.R.C. § 245A(e)(3).
[91] I.R.C. § 59A.
[92] Kamin *et al.*, *supra* note 54, at 56.
[93] R. Avi-Yonah, *The International Provisions of the TCJA: A Preliminary Summary and Assessment* (Univ. of Mich. Pub. L.

Research Paper No. 605, 2017), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3193278.

[94] I.R.C. § 59A(a). *See* JCS-1-18, *supra* note 60, at 399-409.

[95] 2% or higher for banks and registered securities dealers.

[96] I.R.C. § 59A(e)(1).

[97] I.R.C. § 59A(c)(2)(A). *See* Prop. Treas. Reg. § 1.59A-1 *et seq*., REG-104529-18 (Dec. 13, 2018) for guidance on how to determine the tax on base erosion payments of taxpayers with substantial gross receipts.

[98] I.R.C. § 59A(c)(4)(B).

[99] As defined in I.R.C. § 59A(g).

[100] I.R.C. § 59A(d); Prop. Treas. Reg. § 1.59A-3. In general, base erosion payments do not include payments for cost of goods sold such as manufacturer's raw materials (subject to exceptions), certain services nor certain qualified derivative payments. I.R.C. § 59A(h).

[101] I.R.C. § 59A(b)(2). Note, certain banks and securities dealers are subject to higher rates. I.R.C. § 59A(b)(3).

[102] I.R.C. § 59A(b)(1).

[103] I.R.C. § 59A(c)(1).

[104] Avi-Yonah, *The International Provisions of the TCJA*, *supra* note 93.

[105] Notice 2018-7, 2018-4 I.R.B. 317.

[106] JANE G. GRAVELLE & DONALD J. MARPLES, CONGRESSIONAL RESEARCH SERV., R45186, ISSUES IN INTERNATIONAL CORPORATE TAXATION: THE 2017 REVISION (P.L. 115-97) (2018), at 39.

[107] I.R.C. § 965(o).

[108] Andrew Velarde, *AICPA Lobbying for Downward Attribution Transition Tax Relief*, TAX NOTES INT'L, Mar. 19, 2018.

[109] GRAVELLE & MARPLES, *supra* note 106, at 40.

[110] Stephen E. Shay, *Treasury Can Close a Potential Loophole in the Treatment of Deferred Foreign Income in the Tax Cuts and Jobs Act – Will It Act?* (Dec. 26, 2017),

https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3093379; Lynnley Browning, *Tax Law Quirk Could Help Apple and Microsoft Lower Their Bills*, BLOOMBERG, Apr. 3, 2018, https://www.bloomberg.com/news/articles/2018-04-03/irs-seen-blessing-tax-law-quirk-that-could-help-apple-microsoft.

[111] GRAVELLE & MARPLES, *supra* note 106, at 40.

[112] Avi-Yonah & Mazzoni, *BEPS, ATAP and the New Tax Dialogue: A Transatlantic Competition?* (Univ. of Mich. Pub. L. Research Paper No. 612, 2018), at 4–5, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3204242.

[113] Avi-Yonah, *The International Provisions of the TCJA: Six Results after Six Months* (Univ. of Mich. Pub. L. Research Paper No. 621, 2018), at 3, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3242008.

[114] GRAVELLE & MARPLES, *supra* note 106, at 38.

[115] For a discussion of how a partnership can be used to "game" around the interest limitation with preferred equity, *see* Kamin *et al.*, *supra* note 54, at 63–65.

[116] GRAVELLE & MARPLES, *supra* note 106, at 39.

[117] Kamin *et al.*, *supra* note 54, at 57.

[118] Rebecca M. Kysar, *Judging the New International Tax Regime: Testimony Before the U.S. Senate Committee on Finance* (Apr. 24, 2018), at https://www.finance.senate.gov/imo/media/doc/24APR2018KysarSTMNT.pdf.

[119] Kamin *et al.*, *supra* note 54, at 57–58.

[120] GRAVELLE & MARPLES, *supra* note 106, at 38.

[121] Kamin *et al.*, *supra* note 54, at 56.

[122] *Id.*

[123] GRAVELLE & MARPLES, *supra* note 106, at 38.

[124] Kamin *et al.*, *supra* note 54, at 61.

[125] *See* Andrew Velarde, *Failing BEAT's Services Cost Method Exception Could Cost Big*, TAX NOTES INT'L (Jan. 29, 2018), at 419–21; Martin Sullivan, *Economic Analysis: Can Marked-Up Services Skip the BEAT*, TAX NOTES (Feb. 5, 2018), at 705–09;

Manal Corwin *et al.*, *A Response to an Off-Beat Analysis*, TAX NOTES (Feb. 12, 2018), at 933–36; Alexander Lewis, *Officials Differ on Importance of BEAT Legislative History*, TAX NOTES TODAY (Feb. 16, 2018); Martin Sullivan, *Marked-up Services and the BEAT, Part II*, TAX NOTES (Feb. 26, 2018).

[126] Prop. Treas. Reg. § 1.59A-3(b)(3)(i).

[127] GRAVELLE & MARPLES, *supra* note 106, at 36, 38.

[128] *Id.* at 38.

[129] Yalman Onaran, *How Trump's Tax Overhaul Could Hit Big Foreign Banks*, BLOOMBERG (Dec. 29, 2017), https://www.bloomberg.com/news/articles/2017-12-29/trump-s-tax-overhaul-may-punish-foreign-banks-with-u-s-units.

[130] GRAVELLE & MARPLES, *supra* note 106, at 38.

[131] Joseph A. Goldman *et al.*, *The U.S. Tax Cuts and Jobs Act: Fundamental Changes to Business Taxation*, JONES DAY WHITE PAPER (Jan. 2018), at 13, https://www.jonesday.com/files/Publication/f54dfba7-db13-432b-8de2-b10cde64f163/Presentation/PublicationAttachment/3112e6aa-1d80-42fc-8bd7-bea4a7ea6c76/Tax%20Cuts%20and%20Jobs%20Act2.pdf.

[132] *Id.*

ESTABLISHING THE STRATEGIC VALUE OF THE IN-HOUSE LEGAL DEPARTMENT

by

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Managers often marginalize the significance of the in-house legal department to the generation of corporate strategic value.[1] This outlook reveals a gross misreading of the emerging challenges that developments in the legal environment will place upon organizations over the next few years. Intellectual property law protections will become increasingly important to the generation of organizational value.[2] Cybersecurity and data protection issues represent chief concerns in the areas of compliance, risk management, and business litigation.[3] The conceivable damage to innovation, global trade, and economic growth posed by cybercrime will force legal counsel, corporate executives, and technology experts to work collaboratively on creating proactive approaches to cyber security risk-management practices.[4] As managers will regularly perform an increasing amount of business decisions in the years ahead that will require an appreciation of the value derived from corporate legal strategy,[5] companies will face an ever-increasing need to reexamine and adjust unrecpetive managerial attitudes toward the strategic value of the in-house legal department.

In-house counsel will occupy a critical role in supporting techniques for altering unrecpetive managerial attitudes toward the strategic value of the in-house legal department. The greater demands and expectations placed upon in-house counsel will drive efforts toward promoting an understanding of the need for,

and value of, effective corporate legal strategy across the organization.[6] General counsel serve an important strategic role in acting as boundary spanners between the lawyer mentality and the business perspective.[7] Bridging the gulf between lawyers' and managers' respective mental models will represent a decisive factor in creating innovative organizational processes by combining legal tactics with managerial insight.[8] General counsel, through their dual responsibilities as legal counsel and business value creators, are now denoted as "strategic partners" within organizations.[9] There is a lack of consensus, however, among in-house general counsel with respect to techniques that will alter unreceptive managerial viewpoints toward the strategic value of the legal department in the corporate setting. The purpose of this article is to develop such a consensus by outlining the recommendations of in-house general counsel from a 3-round Delphi study generated in response to following open-ended question: What types of practices will help in-house lawyers demonstrate how the legal department brings strategic value to the company?

STUDY BACKGROUND

A 3-round Delphi study was conducted to address the general problem concerning the severe limitations placed on the organizational ability to derive strategic value from the law due to the lack of integration between legal strategy and business strategy in the corporate setting. The specific problem that addressed in this study is that managers hold unreceptive viewpoints toward the strategic value of law within the corporate setting.[10] Although in-house general counsel working across business industries in the United States stand in a position to develop techniques for altering unreceptive managerial viewpoints toward the law, a lack of consensus exists among them with regard to techniques that will alter unreceptive managerial viewpoints toward the strategic value of law within

the corporate setting. The purpose of the study was to build this consensus.

During the first round, a study panel comprised of in-house general counsel working across business industries in the United States responded to an electronic questionnaire containing 6 broad, open-ended questions. The second-round questionnaire consisted of theme statements derived from panelists' responses to the first round questionnaire. Panelists rated each statement on the second round questionnaire against 2 separate 5-point Likert scales: desirability and feasibility. Any statement where the collective frequency of panelists' top 2 responses (rating of 4 or 5) was 70% or higher on both the desirability and feasibility scale passed to the third round. The third-round questionnaire consisted solely of theme statements carried over from Round 2. In Round 3, panelists rated each remaining statement against 2 other scales: importance and confidence. The statements where the collective frequency of panelists' top 2 responses (rating of 4 or 5) was 70% or higher on both the importance and confidence scales formed a consensus on techniques that will alter unreceptive managerial viewpoints toward the law within the corporate setting.

The final list of 25 theme statements generated by the study panel in Round 3 encompassed the following categories: (a) managerial attitudes toward lawyers and the law; (b) relationships between lawyers and non-lawyer managers; (c) leadership in the legal profession; (d) in-house general counsel and the strategic value of the in-house legal department; and (e) law, legal strategy, and competitive advantage. The discussion in the present article will focus on the fourth major category: in-house general counsel and the strategic value of the in-house legal department. An understanding of the roles and functions of in-house general counsel will set the stage for examining the value of the in-house legal department.

LITERATURE REVIEW

The Delphi Method

The Delphi method encompasses an iterative process for developing consensus among a panel of experts through the dissemination of questionnaires and feedback.[11] Delphi is geared toward the formation of consensus in instances where a deficiency of scholarship exists on a given research topic.[12] Delphi studies occur through a series of iterations (rounds), beginning commonly with the distribution of a broad, open-ended questionnaire in the first round and concluding with the development of consensus in the last round.[13] The technique was forged by the RAND Corporation in the 1950s as a means to generate forecasts in connection with military technological innovations.[14] Scholars have applied the Delphi method to problems in multiple areas, including environmental and social studies, medicine, government, and industrial/business research.

The Delphi design consists of four principal characteristics: (a) participant selection is based on predefined qualifications; (b) participants communicate exclusively with the study facilitator and are anonymous to other participants; (c) information is gathered and redistributed to study participants by the study facilitator through a series of iterations, and (d) the responses of individual participants are combined by the study coordinator into a collective group response.[15] Numerous benefits accompany the Delphi method, including the minimization of biases stemming from face-to-face interaction, the gathering of varied experts from isolated geographical locations, the abolition of prolonged face-to-face meetings, and the facilitation of greater inclusion from groups of individuals who are habitually omitted from participation in academic research.[16] Rigor is central to the Delphi method, wherein researchers commonly use rating scales to evaluate panelists'

responses along four key dimensions: desirability, feasibility, importance, and confidence. These four dimensions represent the amount of information required for the adequate assessment of an issue under the Delphi method.[17]

Role and Functions of In-House General Counsel

This section will contain an overview of recent scholarship on the growth of general counsel in the corporate environment, the ways through which general counsel create organizational value, the tensions inherent in the roles and responsibilities that characterize the general counsel position, and the growing importance of general counsel to business strategy. The literature in this section underlines the critical role that general counsel play in facilitating organizational legal strategy.

Evolution of General Counsel in the Corporate Environment:

Occupational statistics centered on the positions of in-house general counsel reveal a demographic shift within the legal profession over the last few years. Some lawyers within the legal community have by tradition regarded engagement in private practice legal practice as superior to employment as in-house counsel in the business setting.[18] There is some evidence to suggest that this perspective is changing as in-house counsel continue to gain greater recognition and wield greater power in the corporate sector.[19] Approximately 15% of all practicing attorneys worked as in-house counsel in 2014.[20] According to the Association of Corporate Counsel, the number of available in-house lawyer positions rose by approximately 10% in 2015.[21] The results of an analysis conducted by Russell Reynolds Associates of all general counsel appointments within Fortune 500 companies between 2011 and 2012 revealed a 25% increase in the practice of hiring general counsel with prior experience

working as general counsel.[22] Comparable developments are apparent in the increasing number of lawyers serving on the board of directors or in the position of chief executive officer.[23] The American Bar Association, as well as many state bar associations, now offer sections and committee memberships geared toward the niche practice of in-house legal practice in the corporate setting.[24] Redeployments of company resources are increasingly accompanying demographic shifts associated with the increasing reallocation of attorneys to in-house counsel positions. The results from a 2015 Global General Data Counsel Survey of general counsel from Fortune 1000 companies suggest that corporate legal departments are beginning to see increased human resource and financial support from their respective organizations.[25] Scholars have attributed the growth of general counsel positions to a variety of factors, including (a) rapid advancement of information technology innovations; (b) changing business models within the legal services industry, and (c) mandates for legal cost reductions from business clients.[26] The rise of in-house legal counsel may reflect an increased understanding of the need for, and value of, effective corporate legal strategy.[27]

Value Creation and the Role of General Counsel:

Several scholars have studied the connection between the presence of general counsel and the creation of organizational value. Ham and Koharki examined whether the decision by a company to appoint corporate general counsel to senior management affected the firm's credit risk assessment.[28] Litov et al. concluded that placing a lawyer on the board of directors led to a 9.5% increase in company value.[29] Kwak et al. concluded that if a company has a general counsel on its senior management team, then the company is more likely to issue more frequent and more accurate earnings forecasts than a company without a general counsel in senior management.[30]

Beyond value creation through mere presence, general counsel also drive value creation through their day-to-day functions. The vision that lawyers serve as gatekeepers may lend partial support to the proposition that in-house lawyers must work constantly to protect the organization from both internal and external legal threats.[31]

The value creation attributed to general counsel echoes the variety of roles that they occupy within organizations. Three general spheres comprise the tasks of senior in-house counsel: corporate governance monitoring, regulatory compliance, and business development.[32] A range of functions and responsibilities emerge from these spheres, including arbitrator, legal advisor and educator, negotiator, strategic planner, and crisis manager.[33] General counsel also have oversight responsibilities focused on preserving firm compliance with applicable laws and regulations as well as requests stemming from governmental investigations.[34] Other scholars have noted that the roles and responsibilities of general counsel also encompass managing prospective litigation, maintaining responsible corporate practices, and projecting the effect of regulatory changes on firm operations and performance.[35]

General counsel positions, as a result of the increased range of responsibilities falling to their positions and departments, continue to grow in prestige and recognition. Due to the growing reduction in boundaries between law and business, general counsel continue to gain acknowledgment as critical members of senior/executive level management.[36] The growing burdens levied by an increasingly colossal and convoluted hodgepodge of local, state, and federal regulations in the business environment are driving this expansion.[37] Mounting acknowledgment that law is also a potential source of value creation within the organization, in turn, drives further expansions to the roles and responsibilities assigned to the

general counsel's office.[38] Scholars have emphasized that the attendance of well-rounded, business-oriented counsel at the strategic planning table will constitute a core requirement for long-term success in the years to come.[39] General counsel, due to their dual responsibilities as both legal counsel and business value creators, are now denoted as "strategic partners" within organizations.[40]

The Growing Importance of General Counsel to Business Strategy:

General counsel possess a broad array of non-legal skills in addition to legal knowledge and acumen. According to the results of a survey of chief legal officers, 76% have played an increasing role in corporate strategy development in recent years.[41] To thrive in such a role, general counsel have needed to further develop an array of non-legal skills, including developed understandings of human resources, business management, project management, financial management, budgeting, procurement, sales, information technology, asset management, and marketing.[42] In addition to increased participation in business strategy discussions, general counsel have also championed high-level legal strategies and encouraged managerial employees to assume more participatory, hands-on roles in legal affairs affecting their organizations.[43] The role of general counsel will require an understanding of the roles played by diverse parties throughout the firm and the skills necessary to act as a buffer between lawyers and managers.[44] Chief legal strategists will require an array of qualities to drive legal strategies in such an interdisciplinary context, including:[45]

- Strong business fluency, financial literacy, and operational experience
- Effective communication skills
- Business leadership experience

- Creative problem-solving capabilities
- Change-agent mentality
- Ability to act as team-players and team-builders
- Strategy execution capabilities

The legal skills and business expertise of general counsel have noteworthy effects outside of business strategy discussions. General counsel serve an important strategic role in acting as boundary spanners between the lawyer mentality and the business perspective.[46] Bridging the gulf between lawyers' and managers' respective mental models denotes a decisive factor to combining legal tactics with managerial insight in an effort to assimilate collective knowledge into innovative processes.[47] General counsel occupy unique positions within organizations that permit them to subvert legal groupthink stemming from close ties between managers and directors.[48] To identify how the legal department can play a leading role in achieving the company vision, general counsel must consider their connections and interactions with other organizational departments.[49] General counsel stand in a strong position to positively alter managerial views of the law and of the legal department's role in the organization.[50]

RESEARCH DESIGN AND METHODOLOGY

Panelist Selection

Participant selection is a critical component of the Delphi design. Delphi researchers select participants based on participants' expertise with the issue(s) involved in the study, rather than selecting participants using representative random samples.[51] Researchers have used a variety of criteria to identify

suitable Delphi panelists, including years of work experience, education, professional qualifications, licensures, and professional publications.[52] Participants in this Delphi study satisfied the following eligibility requirements: (a) juris doctor degree from an ABA-accredited law school; (b) license to practice law in at least 1 state; (c) 5 years of business industry experience, and (d) currently serve as in-house general counsel for an organization headquartered in the United States. Nineteen in-house general counsel participated in the study.

Data Collection and Data Analysis

To address the theme of law, legal strategy, and competitive advantage, the first question on the Round 1 questionnaire solicited panelists' recommendations in response to the following open-ended question: What types of practices will help in-house lawyers demonstrate how the legal department brings strategic value to the company? The instructions asked panelists to provide a minimum of 3 – 5 recommendations in response to the question, along with a short description for each recommendation. The study panelists generated 84 recommendations in response to the question. By means of thematic content analysis, I generated 10 theme statements from the panel's first round recommendations. Table 1 contains an overview of the relevant Round 1 results.

Table 1

First Round Coding Results

Demonstration of strategic value	40	
Involvement/participation	401	
Presence in all stages of business process	4011	1 3
Collaborative efforts to balance risk/reward	4012	6

Training/education	403	
Legal consequences using examples/cases/demonstrations	4031	7
Costs/revenue	404	
Cost effective options to address legal issues	4041	12
Legal department as source of revenue	4042	2
Results	405	
Success in managing legal matters	4051	6
Utilization of appropriate performance metrics	4052	4
Accountability and integrity	406	2
Communication	407	4
Proactivity	408	
Proactively address legal issues/trends/risks by taking active role	4081	28

The second-round questionnaire included the 10 theme statements derived from panelists' responses to the first round questionnaire. Panelists rated each statement on the second round questionnaire against using separate 5-point Likert scales for desirability and feasibility. The scale measuring desirability ranged from (1) highly undesirable to (5) highly desirable, whereas the scale measuring feasibility ranged from (1) definitely infeasible to (5) definitely feasible. The second round questionnaire included a list of references and definitions to provide panelists with clarity as to the meaning of each item on the desirability and feasiblity scales respectively. Any statement where the collective frequency of panelists' top 2 responses (rating of 4 or 5) was 70% or higher on both the desirability and feasibility scale would carry over to the third round questionnaire. As indicated in Table 2, 8 of the 10 statements satisfied the 70% threshold and carried over to Round 3. The panelists in Round 2 also provided an array of optional comments and explanations in support of their reasoning.

Table 2

Round 2 Ratings

Statement	Desirability %	Feasibility %
Accepting responsibility for the department's decisions.	83%	96%
Providing timely, effective legal advice and updates on legal matters affecting the organization.	100%	100%
Participating in business processes.	91%	74%
Collaborating w/managers to balance the risks/rewards associated w/business decisions.	100%	74%
Providing training on the legal consequences of management decisions using real world examples, cases, or demonstrations.	100%	91%
Finding cost effective ways to address legal issues.	91%	70%
Finding innovative ways for the legal department to generate revenue.	**57%**	**17%**
Successfully managing litigation and other legal matters.	96%	87%
Adopting and meeting appropriate performance metrics.	**70%**	**30%**
Understanding the business and proactively addressing legal issues, trends and risks that impact the company.	100%	96%

The third-round questionnaire included the 8 statements that carried over from Round 2. The panelists applied further ratings for importance and confidence to each statement using

two additional 5-point Likert scales. The scale measuring importance ranged from (1) most unimportant to (5) very important, whereas the scale measuring confidence ranged from (1) unreliable to (5) certain.[53] As indicated in Table 3, only 4 of the 8 statements satisfied the 70% threshold for both importance and confidence. Similar to Round 2, the panelists in Round 3 provided an array of optional comments and explanations in support of their reasoning.

Table 3

Round 3 Ratings

Statement	Importance %	Confidence %
Understanding the business and proactively addressing legal issues, trends and risks that impact the company.	89%	89%
Collaborating w/managers to balance the risks/rewards associated w/business decisions.	**79%**	**63%**
Participating in business processes.	84%	74%
Accepting responsibility for the department's decisions.	**84%**	**63%**
Providing training on the legal consequences of management decisions using real world examples, cases, or demonstrations.	84%	79%
Providing timely, effective legal advice and updates on legal matters affecting the organization.	84%	79%
Successfully managing litigation and other legal matters.	**79%**	**63%**
Finding cost effective ways to address legal issues.	**74%**	**68%**

Exploring the Results

The key findings, depicted by the theme statements contained in Table 3, represent a consensus by the study panel on practices that will help in-house lawyers demonstrate how the legal department adds strategic value to the company. The practices for demonstrating the strategic value of the legal department, in turn, represent a subset of techniques for altering unreceptive managerial viewpoints toward the strategic value of law within the corporate setting. The findings suggest that proactive attention to legal issues, providing legal training, participating in business processes, and the effective delivery of legal advice will help in-house counsel demonstrate the strategic value of the legal department.

Participation in Business Processes

The collective ratings supplied by the panelists in Rounds 2 and 3 indicated high levels of agreement with the desirability, feasibility, importance, and confidence of in-house counsel demonstrating the strategic value of the legal department by participating in business processes. This result is consistent with research by Bird and Orozco, Siedel and Haapio, and Bagley whose works have highlighted the importance of involving legal counsel to a greater degree in company business processes.[54] Despite such scholarship, however, there remain gaps in the literature with respect to suitable mechanisms and methods for putting these theoretical concepts into actual practice within the organization. Questions related to where, when, and how organizations can involve legal counsel to a greater degree in company business processes remain chiefly unanswered.

In addressing these questions, two considerations are paramount: cost concerns and organizational conflict. Prudence

and business judgment relative to overt and hidden costs must accompany any decision to foster greater involvement by in-house counsel in company business processes. Although organizations across industries have hired additional in-house counsel and allocated additional resources to their legal departments in recent years, available evidence suggests that this growth is reactive, rather than proactive, in nature.[55] In the face of sentiments that cost minimization represents a primary charge of corporate legal departments, any proposal to increase the participation of in-house counsel in company business processes must include an articulation of the resulting strategic value to the organization. Alongside cost considerations, it is also necessary to consider the organizational conflict that will result from the increased involvement of in-house counsel in company business processes. Conflict between in-house counsel and other members of the organization, largely driven by differences in behavior and decision-making,[56] often leads to anxiety over attorneys' authority over decisions affecting the employer-employee relationship,[57] perceptions that in-house counsel are not team players,[58] and beliefs that law is an impairment to organizational growth.[59] Failing to recognize and/or address such conflict can lead to disastrous consequences.[60]

Training and Education

The collective ratings supplied by the panelists in Rounds 2 and 3 indicated high levels of agreement with the statement that in-house counsel can the strategic value of the legal department by providing training on the legal consequences of management decisions using real world examples, cases, or demonstrations. This result is wholly consistent with existing literature on workplace training. Alignment between HR training initiatives and the organization's competitive strategy serves as a powerful source of competitive advantage that enhances training effectiveness

and cannot be easily imitated by an organization's competitors.[61] It is important to recognize, however, that diverse internal and external factors may impede or enhance training effectiveness, including how training is delivered (classroom vs. online), whether training is voluntary or required, the manner in which training importance is conveyed to employees, whether training takes place after hours or during the workday, the characteristics of the training facilitator, and employee satisfaction with the instructional experience.[62]

Due to the limited information provided by the panelists, questions remain as to how to properly frame and conduct training on the legal consequences of management decisions. For instance, are there assumptions among general counsel that training sessions using the traditional classroom lecture/Q&A format are most effective? Do general counsel place any value in team-building exercises or personal reflections in connection with the training process? Does the content of such training include only a focus on black letter law, or does training also include materials related to the value of legal strategy and interactions with in-house counsel? Does training encompass only a reactive approach to law, or is training designed to support a preventative/proactive view toward law among managerial employees? Questions also emerge relative to the effectiveness of training conducted by in-house counsel, given the factors that drive organizational conflict between in-house counsel and other members of the organization as noted in the previous section.

Communication

The collective ratings supplied by the panelists in Rounds 2 and 3 indicated high levels of agreement regarding in-house counsel demonstrating how the legal department adds strategic value by providing timely, effective legal advice and

updates on legal matters affecting the organization. This finding is consistent with the work of scholars who have described effective communication as a critical attribute indispensable to modern in-house legal practice.[63] Mitigating or preventing the organizational conflict between in-house lawyers and managers described above will oblige both parties to assimilate their respective abilities and spheres of knowledge through using effective communication. During the course of the main study, several panelists commented that the timely delivery of effective legal advice by in-house counsel is a non-negotiable value proposition for every in-house legal department. As discussed more fully below, the ability of a legal department to provide timely, effective legal advice and updates is largely contingent on whether the department takes a reactive posture or a proactive posture to legal matters affecting the organization.

Proactive Approach to Legal Issues

The collective ratings supplied by the panelists in Rounds 2 and 3 indicated high levels of agreement with the statement that in-house counsel can demonstrate the strategic value of the legal department through understanding the business and proactively addressing legal issues, trends and risks that impact the company. The principles of proactive law encompass (a) practices, skills, and knowledge that support identifying future legal problems in time to take preventive action; and (b) the identification of business opportunities in time to exploit conceivable benefits.[64] Proactive law centers on the future-oriented integration of legal skills and knowledge firmly into corporate culture, strategy, and day-to-day activities.[65] Proactive law concepts have supported efforts by in-house legal departments to transition from reactive postures to proactive postures.[66] A law department embracing the reactive posture constantly functions in firefighter mode by responding to critical events only as they arise.[67] Such an

approach reduces the department's capacity to systematically identify and prioritize future business risks. Law departments that embrace a proactive posture, by contrast, pre-emptively address known risks and the potential legal consequences of developing business trends.[68]

CONCLUSION

This 3-round Delphi study was conducted to address the specific problem concerning unreceptive managerial viewpoints toward the strategic value of law within the corporate setting. While in-house general counsel working across business industries in the United States are poised to develop techniques for altering unreceptive managerial viewpoints toward the law, a lack of consensus exists among them with respect to techniques that will alter unreceptive managerial viewpoints toward the strategic value of law within the corporate setting. To address the theme of in-house general counsel and the strategic value of the in-house legal department, and to develop techniques for altering unreceptive managerial viewpoints toward the strategic value of law within the corporate setting, the Round 1 questionnaire solicited panelists' recommendations in response to the following open-ended statement: What types of practices will help in-house lawyers demonstrate how the legal department brings strategic value to the company? The final list of theme statements generated by the study panel in Round 3 encompassed the following actions: (a) participating in business processes; (b) providing training on the legal consequences of management decisions using real world examples, cases, or demonstrations; (c) providing timely, effective legal advice and updates on legal matters affecting the organization; and (d) understanding the business and proactively addressing legal issues, trends and risks that impact the company. The key findings of this study represent a consensus by the study panel on actions for demonstrating the strategic value of the in-house

legal department. The actions for demonstrating the strategic value of the in-house legal department, in turn, denote a set of techniques for altering unreceptive managerial viewpoints toward the strategic value of law within the corporate setting.

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REFORMING DODD-FRANK: IS THE FINANCIAL CHOICE ACT – OR ANY OTHER LEGISTLATION PROPOSED – THE RIGHT CHOICE?

by

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INTRODUCTION

A political storm has arisen with the election of President Donald Trump in 2016. President Trump inherited a Republican Senate and House of Representatives, somewhat comparable to the election of the Democrat President, Barack Obama, who initially had a Democrat legislative body eight years before. The U.S. economy was radically different at each commencement, with Obama facing the greatest financial crisis since the Great Depression of the 1930s while Trump witnessed a mainly recovered and prosperous economy. When President Trump took office, the unemployment rate had fallen from approximately 10 percent to below five percent,

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bordering on what some economists would term "full employment." Nevertheless, the economic status of many Americans remained stagnant as of 2016, causing an unexpected surge of dissatisfied voters who opted to change their political party-designation based upon the hope of the fulfillment of the slogan "Make America Great Again," the assumption underlying the slogan being that the United States no longer had the global economic and political power it once possessed.

A major alleged cause for the claim that America is not great was the proliferation of governmental regulation and oversight that allegedly was responsible for less than desired economic prosperity for middle- and lower-class American workers. This Article will explore the pros and cons of federal financial regulation – and efforts made to overturn a vast segment of the regulations. We will examine key provisions of the Dodd-Frank Act and the regulatory provisions enacted pursuant thereto that often cause consternation among the affected financial participants.

DODD-FRANK ACT AND REGULATIONS

President Trump's Executive Orders

President Donald Trump issued a series of executive orders to limit government regulation of large segments of the economy. One of his first executive orders was entitled, "*Reducing Regulation and Controlling Regulatory* Costs."[1] Historically, the claim by President Trump that excessive regulation impeded economic growth was the not the first such claim by a Republican President. President Ronald Reagan, in office from 1981 to 1989, also attributed the financial crisis he inherited upon taking office to over-regulation of industry; therefore he issued Executive Order 12291 as one of his first

actions as President.[2] That order, which is similar in scope and content to President Trump's Executive Orders of January 30, 2017 stated that each agency shall consider and prepare an analysis of the regulatory impact of every major rule.[3] President Trump issued a further Executive Order[4] requiring the head of each executive agency to submit within 180 days a proposed plan to reorganize the agency in order to improve its efficiency, effectiveness, and accountability. Recommendations sought were the elimination of unnecessary agencies, components thereof, agency programs, and the merger of functions. The factors to be considered are:

(i) whether some or all of the functions of an agency, a component, or a program are appropriate for the Federal Government or would be better left to State or local governments or to the private sector through free enterprise;
(ii) whether some or all of the functions of an agency, a component, or a program are redundant, including with those of another agency, component, or program;
(iii) whether certain administrative capabilities necessary for operating an agency, a component, or a program are redundant with those of another agency, component, or program;
(iv) whether the costs of continuing to operate an agency, a component, or a program are justified by the public benefits it provides; and
(v) the costs of shutting down or merging agencies, components, or programs, including the costs of addressing the equities of affected agency staff.[5]

Thus, the combined Presidential and Congressional actions raise the issue of governmental regulatory actions as roadblocks to economic expansion.

Purposes of Regulatory Oversight under the Dodd-Frank Act

The *Dodd-Frank Act*[6] was passed in 2010 solely by the unanimous vote of Democrat representatives in the House and the required super-majority of Senators in the Senate. In the face of total opposition of Republican legislators, the Act was signed into law by President Barack Obama in order to curb alleged significant abuses and lack of oversight by federal agencies that led to the 2007 recession. The demise of Lehman Brothers and the near demise of major financial institutions led the federal government to institute a major bailout of troubled banks and other entities to prevent the collapse of these institutions both domestically and worldwide.

Factors That Led to Economic Collapse:

There were a number of causes that led to the critical juncture of determining which responses were to be undertaken by the federal government. Those opposed to government bailouts believed that troubled institutions should be allowed to liquidate in accordance with market theory under capitalism or other economic theories[7] while other commentators and government officials such as U.S. Treasury Secretary Henry Paulson Jr. and Federal Reserve Chair Ben Bernanke believed that the failure to rescue them through TARP program[8] would cause a massive financial breakdown comparable to or worse than the Great Depression of the 1930s.[9]

The ostensible causes for the 2007 financial near collapse are many and are often recited according to the ideological preferences of the commentators. Nevertheless,

there appears to be a consensus of the major factors that led to it. The initial cause appears to be the grant and sale of subprime mortgages, that is, mortgage loans grated to home buyers who could ill afford to pay the monthly premiums particularly when the premiums initially given at "teaser" rates (rates that were very low but due to rise after one or more years) or if the homeowner lost his or her job or became incapacitated. Inasmuch as the cost of housing kept rising almost daily, there appeared to be no risk because the homes could be sold at a profit in the event the homeowner was unable to make the monthly payment. These loans, often consisting of the entire often highly inflated value of the home and even the closing costs, were pooled, packaged into levels of tranches depending on risk at increasing interest rates and sold to investors, including pension and mutual funds and foreign banks. Such investors heretofore believed the loans to be nearly risk-free.

The pooled mortgages were used to back securities called collateralized debt obligations. The major rating agencies gave the instruments unjustified high ratings, either due to lack of knowledge of the new forms of complex financial securities or outright neglect, as they profited from the fees from making the ratings in competition with each other. When homeowners began having difficulties making the premium payments, their properties were foreclosed upon. These many thousands of foreclosures were partly responsible for the ensuing death spiral of bank closures and job losses.[10] As described by another scholar, the death spiral consisted of a fall in the value of the inflated asset value that was backed by high leverage which then led to margin calls compelling investors to sell the asset which then lessened the value of the asset; the fall in value lessened the collateral backing the initial leveraged credit boom; which in turn forced a fire sale of the

asset and the cascading resulting financial events vicious circle of repeated events.[11]

There were other factors that contributed to the mortgage crisis. Forbes attributed the crisis to the removal of the separation of investment from commercial banks under the *Gramm-Leach-Bliley Act of 2009* (the "*2009 Act*") whereby banks were now able to engage in high risk behavior but also buttressed by the guaranteed deposits by the Federal Deposit Insurance Corporation ("FDIC"); the Fed's low interest prime rates; the new forms of loans by poorly understood mechanisms; credit agencies compliance; unregulated derivatives and their uncontrolled explosion; nonbank financial ventures; looser capital SEC requirements; lack of governmental oversight; compensation tied to short-term performance that led to high risk behavior; Fannie Mae and Freddie Mac underwriting of high risk loans; among other factors.[12]

There were international macro-and micro-economic causes for the financial downturn. Among them were the decline in short-term interest rates brought about in part by central banks, the opening of the Chinese economy, and the fall of the Soviet Union that led to downward pressure on wages and prices especially with the decline of labor unions; the growing demand for mortgages; the increased market for securitized bonds; and the rise of shadow banking were all contributing factors in the global economy of which the U.S. is the major player.[13]

Dodd-Frank Act Reform Efforts

The *2009 Act*, consisting of 16 titles, covered the largest segments of the U.S. economy and sought to remedy the perceived fault lines that led to the 2007 crisis. The major

concern was the promotion of the financial stability for the domestic economy.[14] It established the Financial Stability Oversight Council ("FSOC"), whose membership is composed of ten voting members and five non-voting members. Members' duties include identifying risks to the financial stability of the U.S. that could arise from the material financial distress or failure, promote market discipline, responding to emerging threats to the U.S. financial system or activities of the large interconnected banking and non-banking financial sectors of the economy.[15] FSOC is given the authority to supervise nonbanks (engaged in shadow banking), which previously had essentially been unregulated but now often became subsidiaries of bank holding companies.[16] FSOC was empowered to investigate and determine which financial institutions when facing possible collapse could lead to the overall harm to the general economy and make them subject to enhanced and somewhat prudential standards so as to prevent their demise or lessen the negative impacts such as those that ensued in the wake of the collapse of Lehman Brothers and American International Group.[17]

Additional areas of regulation of the *2009 Act* include regulation of hedge fund advisers and others, insurance orderly liquidation for systemic risk companies, additional securities laws regulation, consumer protection by the creation of the Consumer Financial Protection Bureau, and mortgage loan financing.[18]

CONGRESSIONAL RESPONSE THROUGH THE FINANCIAL CHOICE ACT[19]

In the House of Representatives, Jeb Hensarling,[20]chairman of the House Financial Services Committee, introduced a bill, *Financial Choice Act of 2017* (the "*Choice Act*")[21] which, in essence, would substantially

modify or repeal major provisions of the *Dodd-Frank Act of 2010.*[22] The bill was passed by the House of Representatives by a vote of 233 to 186 with no Democrat Representative voting for the bill. There is virtually no chance of passage in the Senate due to the opposition of Democrat senators who would filibuster such enactment and would require a super-majority vote of 60 of the 100 senators. The Republican legislators could attempt to bypass the supermajority required by passing a regulatory relief bill through reconciliation which requires only 50 votes in the Senate.[23] The bill raises, among many other issues, whether the regulations created pursuant to the *Dodd-Frank Act* are excessive and thereby impose too high a regulatory burden upon financial institutions and an impediment to the overall U.S. economy.

Former Senator Phil Gramm,[24] former chairman of the Senate Banking, Housing and Urban Affairs Committee and co-author of the *Gramm-Leach Bliley Act of 1999*,[25] which removed the separation of investment banks from commercial banks, testified on May 10, 2017 that the principal cause of low economic growth in the U.S. has been the result of the regulatory burden placed upon the financial sector of the economy.[26] In essence, the argument made by Gramm and others was that, although major financial institutions can afford to retain compliance officers to supervise and assure regulatory compliance, nevertheless, small entities, particularly community banks and credit unions cannot afford to retain such expertise. The net result allegedly is harm to the overall economy causing it to have less than optimum annual gross domestic product, which averaged 3.2 percent since 1947 and a first-quarter 2017 growth rate of 1.2 percent.[27]

Key Provisions of the Choice Act

Although the *Choice Act*, as of this writing has little chance of passage in the U.S. Senate, nevertheless, it does provide a comprehensive exposure of the Republican platform that has sought to lessen what it perceives to be the regulatory stranglehold on the domestic economy. It is anticipated that the Senate will emulate most of the key provisions of the *Choice Act*. Thus, we will review and discuss the key provisions of the bill and the likelihood of passage by both houses of Congress.

The 350-page proposed *Choice Act* (called by democrats "The Wrong Choice Act")[28], is composed of 12 titles. It substantially alters the *Dodd-Frank Act* by repealing the Volcker Rule, gutting the Orderly Liquidation Authority, and repealing the Fiduciary Duty rule. It practically reduces the protections of the Consumer Financial Protection Bureau, and exempts banks from alleged onerous requirements provided they hold 10 percent of capital assets. The first major change is stated in Title I, Subtitle A, "Ending "Too Big to Fail" and Bank Bailouts, Section 111, repeals the Orderly Liquidation Authority.

Choice Act Title I: Ending "Too Big to Fail" and Bank Bailouts

Repeal of the Orderly Liquidation Authority:

Although Title I of the *Choice Act* emphasizes the termination of taxpayer assistance to troubled banks, it does so by ending the *Dodd-Frank Act* mechanism for identifying those financial institutions which, if they were to become financially insolvent would cause substantial stress to the overall U.S. and global economies as discussed above.[29] Rather than identifying

"systemically important financial institutions" ("SIFIs") by FSOC under Title II of *the Dodd-Frank Ac*t and making them subject to enhanced prudential standards,[30] the *Choice Act* substitutes a bankruptcy procedure for a "covered financial corporation" defined as a bank holding company, which is corporation whose primary purpose is to own, control, or finance subsidiaries having a total consolidated assets of $50 billion or more, or such ownership or control of financial assets relating to depositary institutions represents 85 percent of the consolidated assets of the corporation.[31]

The proposed elimination of the orderly liquidation authority ("OLA") as an alternative to a Chapter 7 or Chapter 11 of the Bankruptcy Code[32] and its replacement of SIFI with an exclusive bankruptcy procedure has engendered much controversy. Most commentators appear to be opposed to the elimination of the Dodd-Frank mechanism.[33] One scholar, while acknowledging that the OLA is not perfect, nevertheless, recognizes it as an essential tool for government regulators to ensure that the financial crisis attributable to a particular SIFI does not escalate to a broader financial crisis. Substituting a bankruptcy judge's determination would be far less effective than that of highly experienced financial regulators who have extensive oversight over the U.S. economy.[34] These regulators are better able to deal with the complexities of the financial system and its relationship with the global economy in place of a bankruptcy judge lacking the overall experience of the regulators.[35] On the other hand, bankruptcy judges are more concerned with protecting the rights of creditors rather than determining what is best for the overall financial economy of the U.S.[36]

Another scholar noted that there were three main criticisms of the OLA: (1) that it creates a moral hazard by allegedly encouraging investors to take more risks because it

gives the government authority to resolve a failed entity, making it more likely to step in if the entity is "too-big-to-fail"; (2) the FDIC is given too much discretion under the OLA because it does not require it to use the "single-point-of-entry"[37] in the event of a crisis but may take options treating creditors differently that they had anticipated; and (3) that the use of bankruptcy procedures is better than the existing mechanism. The response to the criticism is (a) the financial firms, such as General Electric, that have been designated SIFIs instituted structural changes to conform to will no longer be subject to enhanced prudential standards; (b) the complaint can be resolved without the need for ending the OLA; and (c) the bankruptcy procedure is inadequate for large banks and institutions during a financial crisis and may require financial government intervention to prevent widespread disruption. Also, under Dodd-Frank, failing firms are to use the bankruptcy procedure and are required to have "living wills" negating OLA's involvement as a last resort.[38]

Constitutional objections have also been raised, namely, under Section 202 of the *Dodd-Frank Act*. This section, Judicial Review, provides for the commencement of orderly liquidation via a petition to the federal district court when there is a determination by the Treasury Secretary that a financial company satisfies the requirements establishing that the financial company is in default or in danger of default and that such failure would have a serious adverse effect on the financial stability of the U.S. and no other viable alternative is available.[39] If the board of directors of the financial company objects to the petition then the corporation is to be appointed as receiver.[40] The determination is to be confidential without public disclosure, and the court is to determine whether the finding of the secretary is arbitrary and capricious.[41] If the court does not make a determination within 24 hours then the Secretary is authorized to appoint the corporation as receiver

and liquidation is to take place automatically and immediately without further notice. Appeal is limited. There are criminal penalties for persons who recklessly disclose the determination of the Secretary of the petition and pendency of the proceeding.[42]

There appears to be serious constitutional objections to the secrecy of the proceedings; the criminal nature of any disclosure (reason for the provision is to avoid panic in the financial markets) that raises First Amendment freedom of speech issues; the limited time element for a court to make a determination; the mandatory nature of liquidation when other alternatives may be more properly available which may raise Fifth Amendment Takings Clause; the limited nature of judicial review; and other related constitutional issues.[43]

President Trump appears to favor the elimination of the OLA. In a memorandum to the Secretary of the Treasury, the President directed the Secretary to review the authority of the OLA within 180 days from April 21, 2017, consider the potential adverse effects of failing financial on the financial stability of the U.S.; whether invoking OLA could engender a cost to the Treasury; whether OLA's availability could lead to excessive risk taking by creditors, counterparties, and shareholders; whether a new chapter of the Bankruptcy Code would be a superior method of resolving the resolution of failing companies; OLA's anticipated direct and indirect effects; and recommendation for improvement, if any, for legislative changes.[44]

In another memorandum issued the same day, this one concerning FSOC, the President directed the Secretary of the Treasury to conduct a thorough review of FCO's determination and designation processes. He sought information on whether the processes are sufficiently transparent; provide entities with

adequate due process; give market participants the expectation that the Federal Government will shield supervised or designated entities from bankruptcy. He also sought an evaluation of a nonbank financial company's vulnerability to material financial distress; whether any determination as to whether a nonbank financial company's material financial distress could threaten the financial stability of the United States; and whether these processes adequately consider the costs of any determination or designation on the regulated entity.[45]

Repeal of the Volcker Rule:

The *Choice Act* repeals The Volcker Rule, the name of which refers to the former Federal Reserve Chair. Paul Volcker, Federal Reserve Board Chair under both Presidents Jimmy Carter, a Democrat, and Ronald Reagan, a Republican, instituted the Rule while acting as Chairman of the Economic Recovery Advisory Board under President Barack Obama. The financial crisis of 2007 and the events that brought about the closing of numerous banks for the first time since the Great Depression of the 1930s, led to an examination of the causes of the 2007 Recession. Historically, there were bank panics approximately every two decades since the founding of the nation but none for five decades after the *Glass-Steagall Act of 1933*[46] separation of investment from commercial banks instituted under President Franklin Roosevelt.

The separation ended with the passage of the *Gramm-Leach-Bliley Act of 1999* which permitted banks to engage in security offerings and insurance services.[47] A major factor for bank closings allegedly was the removal of the said separation. Although the current President, Donald Trump, stated that he wants to break up the large banking entities effectively by reviving the prior separation of banking entities,[48] it is unclear

whether the president will follow through inasmuch as his Secretary of the Treasury, Steven Mnuchin, and his economic adviser, Gary Cohn, stated that a "21st Century" version of the *Glass Steagall Act* will be endorsed, with its meaning being unclear.[49]

Pursuant to Section 619 of the *Dodd-Frank Act*, a new Section 13 was added to the *Bank Holding Act*. The "Volcker Rule" prohibits an insured depositary institution and holding company controlling an insured depositary institution from engaging in proprietary trading or from acquiring or retaining an ownership interest, sponsoring, or having certain relationships with hedge funds or private equity funds. "Proprietary trading" was given a broad definition that includes: acting as a principal or custodian for an affiliated party; for a trading account used by the entity to acquire or be financially involved in short-term resale; the prohibition of purchasing, selling, or otherwise acquiring or dispensing of stocks, bonds, or other financial instruments for the bank's own account. It covers both banking entities and nonbank (shadow banking) institutions. Title VI of the *Choice Act*[50] repeals Section 619 (the Volcker Rule) and related provisions of the *Dodd-Frank Act*.

The repeal the Volcker Rule has generated more controversy than may have been anticipated. Those scholars favoring the Rule describe the proposed repeal in terms such as "amnesia" by the negligent or deliberate lack of memory concerning the financial crisis that caused the Rule to be enacted. In order to prevent banks from being "too-big-to-fail and making use of the Federal Reserve Bank's discount window, banks should not be permitted to gamble with taxpayer funds.[51] Arguments for the repeal as stated before a House Capital Markets, Securities and Investment Subcommittee in March of 2017 include the alleged inability of

American businesses to obtain affordable financing for long-term growth; their significant increased borrowing costs; lower investment returns for households; harmful effects on corporate bond liquidity causing dealers to be more restrictive in providing liquidity during times of stress; additional restrictions on market making an underwriting activities, all of which serve to impact businesses and restrict their ability to finance short-term needs and plan for long-term growth.[52]

SIFI Designation Repeal:

The newly created Financial Stability Oversight Council ("FSOC"), pursuant to Section 111 of the *Dodd-Frank Act*, was given the power to designate banks and nonbanks for supervision by the Financial Stability Board. There are exceptions for trading in U.S. government securities, underwriting and market-related activities, trading on behalf of customers. FSOC's designation of a financial institution as a "systemically important financial institution" – or SIFI – would bring about a panoply of heightened prudential standards that are onerous to the designated firm.

The designation as a SIFI has been extremely controversial. Thus, when General Electric Capital Corporation received the designation, it sold off billions of dollars of assets to remove the said designation. MetLife's designation on December 18, 2014 was particularly contentious because it is essentially an insurance company with allegedly far less risk investments than the banking sector. It commenced litigation to invalidate the designation and to date has been successful at the District Court level.[53] It is pending appeal but there are indications that the current administration may rescind its appeal of the decision.[54]

Impact on Community Banks

A major concern underlying the *Choice Act* is the impact of federal regulation on smaller financial institutions which lack the resources to comply with onerous regulations. *The Economist* publication illustrates the difficulty by reference to the merger of Standard Financial, a bank with some $488 million and nine branches, with Allegheny Valley Bancorp a smaller neighboring bank in a Pittsburgh suburb. The main reason for the merger, quoting the CEO of Standard, was the cost of regulatory compliance that would not have occurred but for the cost. Larger banks inherently are more able to afford personnel assuring regulatory compliance while smaller entities operating on a smaller profit margin can ill afford the additional regulatory cost structure. Alleged proof of the effect of regulations is the number of community banks that have failed – over 400 – with only five new banks in existence, which provide 43 percent of small business loans nationally. The cost of compliance is illustrated by the additional personnel required to service mortgages, which is at the heart of community bank lending.[55] The Independent Community Bankers of America, an organization representing some 5,800 community banks is supportive of the *Choice Act* provisions reforming and lessening mortgage lending requirements.[56]

It appears that relief for community banks is bipartisan but Democrats object to the overall dismantling of the *Dodd-Frank Act* and would support a separate bill for community bank regulatory relief.[57] There appears to be mixed reactions to the bill from the banking sector. The American Bankers Association ("ABA") President and CEO, Rob Nichols, signified the ABA's support of the bill, which he described as providing "much-needed regulatory relief."[58] The publication *American Banker*, on the other hand, decries the claim of the chair of the committee that community banks are in a crisis due

to the *Dodd-Frank Act*. It alleges that the claim is divorced from reality in two respects, namely, that the main beneficiaries of the legislation are the megabanks, not the vast majority of community banks and that the challenges that community banks have been subjected to predate and were unrelated to the post 2007 financial crisis. It cited the Office of the Comptroller of the Currency, which illustrated that the top four banks accounted for 89 percent of all notional derivatives and 96 percent of credit derivatives. It noted that the *2009 Act* as stated above undermines the Consumer Financial Protection Bureau, nullifies key shareholder rights of all but the largest shareholders, eliminates the orderly liquidation authority of the FDIC, and nullifies the Volcker Rule that reinstitute the risks posed by the pre-2007 crisis[59].

The author further noted that the *Dodd-Frank Act* imposed few restrictions on community banks, which, except for six community banks of 5,000, were not subject to stress tests that were applicable only to banks with over $10 billion in consolidated assets and heightened requirements applicable to banks with over $50 billion in consolidated assets. The *Dodd-Frank Act*'s exemption of banks from most of the regulatory requirements having a 10 percent capital ratio is likely not sufficient to avert a further crisis should a 2007 scenario arise new. A safer capital ratio for regulatory exemptions should be in the range of 20 to 30 percent.[60] Other observers, however, while acknowledging the resiliency of community banks in attempting to comply with regulatory requirements, nevertheless note they have been seriously harmed in their attempt to grow and serve customers in their community. With an average of 42 employees for medium-size banks, they do not have the capacity to understand, train and test for compliance, and apply the multiplicity of rules and regulations required of them.[61]

In an extensive study by the Congressional Research Service,[62] it determined that, although the regulatory burden for small banks has increased in absolute terms, but not so in comparison with larger banks due to accommodations in recent rules and regulations since the financial crisis. It is exemplified by the fact that 13 of 14 "major rules" of baking regulators include either exemptions for small banks or the regulations are tailored to reduce the cost from small banks. The one exception provides regulatory relief for securities backed by capital frequently issued by small banks. None of these regulations are likely to negatively affect the ability of small banks to compete with large banks although there may be some effect in competitive dealings with nonbanks. It further concluded that overestimating the regulatory burden on small banks may lead to policy changes that may have negative consequences for consumers, banks, and the broader economy. Underestimating the regulatory burden could result in further consolidation of banks which, in turn, may lead to shifting of assets from banks to the shadow banking system.[63]

ECONOMIC GROWTH, REGULATORY RELIEF, AND CONSUMER PROTECTION ACT

The *Choice Act*, which was not adopted by the Congress, was followed by the *Economic Growth, Regulatory Relief, and Consumer Protection Act*[64] which was passed by the Senate but not yet adopted by the House. The Act is composed of seven titles, which include the establishments of lower regulatory requirements and oversight from the FSOC for banks between $50 billion and $250 billion in assets; the exemption from the Volcker Rule that bans banks from engaging in speculative trades for banks with less than $10 billion in assets and their total trading assets and trading liabilities that do not exceed more than five percent of total consolidated assets; the requirement that the Federal Reserve

not regulate banks in a "one size fits all" thus removing major roadblocks from community banks in their lending policies; and the allowance of foreign banks to avoid U.S. regulatory scrutiny by tallying their U.S. assets in a manner to keep them under the $250 billion threshold.[65]

The *Economic Growth, Regulatory Relief, and Consumer Protection Act* differs from the *Choice Act* in that its limits the scope of the Volcker Rule rather than provide for its total repeal. Unlike the *Dodd-Frank Act,* which faced near total Republican opposition and total Democrat Senate support, the Crapo bill (named for its sponsor Sen. Mike Crapo (Republican of Idaho), did have some Democrat support by its easing of restrictions on more local community banks. Individuals applying for mortgages in the post-Dodd-Frank era experienced significant roadblocks which often dissuaded otherwise eligible applicants from purchasing homes. Community banks, which relied on the issuance of mortgages for home purchases as a mainstream of their profitability found themselves unable to make loans in many cases due to the inordinate governmental regulatory restrictions. Community banks would have fared better under the *Choice Act* that has an "off-ramp" feature that allowed a qualifying banking organization of any size to elect to be exempt from risk-weighted capital requirements and other restrictions but the Crapo bill lessened oversight for banks with under $10 billion in total assets as stated above.[66]

PRESIDENT TRUMP AND THE ENVIRONMENT AND CONSUMER PROTECTION

Environmental Regulatory Changes

Although a Republican President, Richard Nixon, was responsible for much of the major legislation to protect the

environment, the Trump administration has made a concerted effort to remove alleged barriers to employment due to regulations pursuant to federal statutory obligations. National Geographic, in a lengthy presentation, recited a summary of decisions and actions that directed contradict decades of protection.[67] Among the changes is the Environmental Protection Agency's proposed rule that the Agency to only consider scientific studies for which the underlying data is made available publicly, The problem, according to at least 1,000 scientists who oppose the rule change, is that much of the underlying data is based on personal health information which cannot be made publicly available due to privacy concerns. The Department of the Interior submitted a rule change that removes protection for threatened wildlife species. Other changes affecting the environment is the rollback of car emissions standards; the reorganization of an EPA group that funds research on children's health and environmental health disparities; FEMA expelling of "climate change" from its strategic plan; cuts to clean-energy programs; loosening of regulations on toxic air pollution; removal of the U.S. from the Paris Accord (the only country in the world to do so); the proposal to scrap clean power plan; the halting of mining health studies; and numerous other anti-environmental programs.[68]

Consumer Protection Changes

The *Dodd-Frank Act* created in Title X, the *Consumer Financial Protection Act,* which established the consumer Financial Protection Bureau as an independent agency within the Board of Governors of the Federal Reserve System. The Bureau has been aggressive in combatting anti-consumer actions by credit card companies, pay-day loans that seriously jeopardize by grossly inflated interest charges loans made to

low income employees who require immediate moneys for payment of necessary daily living expenses.

President Trump's appointment of Director Mick Mulvaney signaled the end of its mission to protect consumers. The Bureau, albeit not ended, nevertheless has taken no punitive measures against any alleged wrongdoers and has not sought any funding for the investigation and prosecution of actions against consumers. It has essentially ended its investigation of Equifax with respect to a massive data breach; ended investigations of discriminatory lending practices against minorities, and let go a myriad of other alleged offenses against consumers.[69]

PROS AND CONS OF REGULATION

As with almost any statutory and regulatory enactment, there are winners and losers, but the goal of governmental action is to provide for the betterment of the common good – particularly when there are societal difficulties that need to be addressed. The problem arises that the philosophical differences make compromise exceedingly difficult particularly when the media reflects the nation's deep divide and its audience listens only to the viewpoint desired by it. Thus, while congressional representatives may individually desire to compromise their views for the benefit of their constituencies, the fear of retribution from extremist elements within their particular parties supported by extreme media outlets cause them to maintain uncompromising extreme views. The question posed in this Article is whether the regulatory regime created under different political administrations warrants significant downsizing or reform to accomplish the statutory goals of protection for the common good. There are major arguments that have some merit for either viewpoint.

Arguments in Favor of Regulation

The crisis of 2007 reflected major problems in the financial system that led to systemic risks that ultimately almost caused the collapse of the U.S. and global economies. With a decade to reflect on the events leading up to the crisis it becomes clearer to economists and policy makers what occurred and the options available to both end the economic downturn and attempt to prevent at least near future financial catastrophes. Among the arguments favoring government regulation is that it assists in keeping the markets competitive especially by prosecuting anti-monopolistic behavior; gives voice to consumers who often are ignored in the manipulations accompanying market activities such as drugs, stocks, and other commodity pricing; and compels greater transparency and freedom in the marketplace.[70]

The Geneva Report on Financial Regulation affirms in great part the regulatory environment such as that promulgated under Dodd-Frank.[71] Reflecting in large measure the financial bubble that burst in 2007 and immediately thereafter, it recommends both macro- and micro-prudential approaches for governmental regulation. It further recommends greater intervention in global markets to encourage competition and prevent oligopolistic behavior. Macro-prudential regulation should be countercyclical to negate the effect of bubbles whose bursting can lead to global distress. Regulators should agree on those sectors of the economy of systemic institutions that could cause disruptions and seek global solutions and cooperation.[72]

Arguments Alleging Excessive Regulation Impede Economic Growth

The essence of the claim that excessive regulation impedes growth was succinctly stated in Forbes Magazine. It recited that middle-class households received 15 percent less credit while wealthy households received increased credit of 21 percent; the nation's five largest banks control 44 percent of all U.S. banking assets; the *Dodd-Frank Act* resulted in 24,000 pages of regulations although one-quarter more of the required some 400 regulations are yet to be finalized; that the Volcker Rule which made the corporate bond market less liquid was created although evidenced lacked that proprietary trading contributed to the financial crisis; and that FSOC's extraordinary power to designate nonbanks SIFIs wrongfully designated insurance companies (Prudential and MetLife) as SIFIs causing them to be subject to prudential enhancement even though they did not contribute to the crisis.[73]

Did Bank Regulations Impede Financial Stability?

It appears that the large banks required to undergo stress testing under the *Dodd-Frank Act* have not suffered from the Act's requirements. On June 28, 2017, it was reported that all of the 34 largest U.S. banks required to undergo such testing had passed it thereby permitted to return 100 percent of profits at their option to investors in place of 65 percent last year. Even previously troubled banks, such as Citibank, Wells Fargo (which had undergone extraordinary scandal of creating fraudulent accounts),[74] and the American units of Santander Holdings USA and Deutsche Bank have met regulatory standards.[75] Nevertheless, although the largest banks have managed to recover from their major downturn and near demise of a decade ago, the question remains whether nonbanks (shadow banks) and community banks have also shared in the financial upturn.

CONCLUSION

The above discussion reflects the philosophical differences of the two major political parties. Although the *Dodd-Frank Act* was enacted without any Republican legislator voting for the Act to address the financial crisis of a decade ago, the question arose whether the enormous scope of the enactment was excessive. Republican legislators have historically been opposed to government intrusion, particularly in the financial sector, in the belief that the market should bear the positive and negative consequences of actions taken by all sectors of the economy. The *Choice Act* does reflect the philosophical views of the President, his key advisers, and the Republican Party.[76]

There are valid arguments both for and against significant changes in the *Dodd-Frank* all-encompassing regulatory system that Democrats also agree warrant revisiting. Nevertheless, it appears that the *Choice Act* and subsequent proposed legislation appear to ignore the origin and purposes for the 2010 Act. In any event, the discussion may be moot inasmuch as the Trump Administration may simply refuse to enforce the Dodd-Frank mandates and regulatory scheme. Treasury Secretary Steven Mnuchin, has indicated that he will simply not convene FSOC over which the Treasury Department jurisdiction. The *Dodd-Frank Act* requires the Treasury Secretary to consent to decisions made by the Council. The MetLife litigation whereby MetLife opposed its SIFI designation is on appeal and it appears that the Administration will not pursue the appeal and allow MetLife to prevail. Thus, it remains to be seen whether the changes made legally and politically will bring about another crisis or, as the President alleges, the U.S. will be great again.

ENDNOTES

[1] Exec. Order, 13771, 82 Fed. Reg. 9339 (Jan. 30, 2017)
[2] Exec. Order, 12291, 46 Fed. Reg. 13193 (Feb. 17, 1981)
[3] *See s*upra, note 1, §3(a)(b). For a brief historical context for the Executive Order, see JON MEACHAM, DESTINY AND POWER: THE AMERICAN ODYSSEY OF GEORGE HERBERT WALKER BUSH*,* (Random House, 2015).
[4] Exec. Order, 13781, 82 Fed. Reg. 13959 (Mar. 13, 2017)
[5] *Id*. §2 (a)-(d).
[6] Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).
[7] David M. Herszenhorn, *A Curious Coalition Opposed Bailout Bill*, N.Y. TIMES (Oct. 2, 2008), http://www.nytimes.com/2008/10/03/business/03naysayers.html; Robert A. Levy, *Is the Bailout Constitutional?,* CATO INST. (Oct. 20, 2018), https://www.cato.org/publications/commentary/is-bailout-constitutional.
[8] *Troubled Asset Relief Program*, which was designed to assist major financial sectors in order to stabilize the economy was authorized by Congress through Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 101-136, 122 Stat. 3765, 3767–3800 (2008).
[9] Mike Collins, *The Big Bank Bailout*, FORBES (July 14, 2015, 04:22 PM), https://www.forbes.com/sites/mikecollins/2015/07/14/the-big-bank-bailout/#545e9e9c2d83.
[10] *The origins of the financial crisis*, ECONOMIST (Sept. 7, 2013), https://www.economist.com/schools-brief/2013/09/07/crash-course. See, also, Martin Neil Baily et al., *The Origins of the Financial Crisis*, BROOKINGS INITIATIVE ON BUS. AND PUB. POL'Y (Nov. 24, 2018),

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https://www.brookings.edu/research/the-origins-of-the-financial-crisis/.

[11] Viral Acharya et al., *The Financial Crisis of 2007-2009: Causes and Remedies*, 18 FIN. MRT., INSTITUTIONS AND INSTRUMENTS 89 (2009)

[12] Steve Denning, *Lest We Forget: Why We Had A Financial Crisis*, FORBES (Nov. 22, 2011, 11:28 AM), https://www.forbes.com/sites/stevedenning/2011/11/22/5086/#51c46cfdf92f.

[13] Paul Ramskogler, *Tracing the origins of the financial crisis,* 2 OECD J.: FIN. MKT. TRENDS 47 (2014).

[14] The Act's full title is: An Act to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end "too big to fail", to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes."

[15] Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 111-112, 124 Stat. 1376, 1392-1398 (2010).

[16] For a detailed discussion of shadow banking, see ROY J. GIRASA, SHADOW BANKING: THE RISE, RISKS, AND REWARDS OF NON-BANK FINANCIAL SERVICES (2016)

[17] The prudential standards are set forth in Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 165, 124 Stat. 1376, 1423-1432 (2010).

[18] For an extensive discussion of the Dodd-Frank Act and financial regulation in general see ROY J. GIRASA, CORPORATE GOVERNANCE & FINANCE LAW (2013) and ROY J. GIRASA, LAWS AND REGULATIONS IN GLOBAL FINANCIAL MARKETS (2013).

[19] Financial CHOICE Act of 2017, H.R. 10, 115th Cong. (2017). "An Act to create hope and opportunity for investors, consumers, and entrepreneurs by ending bailout and Too Big to Fail, holding Washington and Wall Street accountable,

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eliminating red tape to increase access to capital and credit, and repealing the provisions of the Dodd-Frank Act that make America less prosperous, less stable, and less free, and for other purposes." CHOICE is the acronym for "Creating Hope and Opportunity for Investors, Consumers and Entrepreneurs."

[20] Republican Congressman, TX 5th.

[21] Financial CHOICE Act of 2017, H.R. 10, 115th Cong. (2017).

[22] Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[23] Donna Borak, *House votes to kill Dodd-Frank. Now what?*, CNN MONEY (June 8, 2017, 6:11 PM), http://money.cnn.com/2017/06/08/news/economy/house-dodd-frank-repeal/index.html.

[24] Senator Phil Gramm (Rep. TX. from 1985-2002), possesses a Ph.D. in economics, was formerly a professor of economics at Texas A&M University, and currently is a visiting scholar at the American Enterprise Institute.

[25] Financial Services Modernization Act of 1999 (Gramm-Leach-Bliley Act), Pub. L. No. 106-102, 113 Stat. 1338 (1999).

[26] *Policies to Grow the Economy hearing before the S. Committee on Budget*, 115th Congress (May 10, 2017) (statement of Phil Gramm, Former Senator, Economic Growth Policies), available at https://www.c-span.org/video/?428277-1/senate-budget-committee-hearing-examines-trump-economic-policy.

[27] BUREAU OF ECONOMIC ANALYSIS, NATIONAL INCOME AND PRODUCT ACCOUNTS GROSS DOMESTIC PRODUCT: FIRST QUARTER 2018 (SECOND ESTIMATE) CORPORATE PROFITS: FIRST QUARTER 2018 (PRELIMINARY ESTIMATE) (2018), available at https://www.bea.gov/newsreleases/national/gdp/gdpnewsrelease.htm..

[28] Jim Puzzanghera, *House votes along party lines to repeal key Dodd-Frank financial reforms*, L.A. TIMES (June 08, 2017,

2:25 PM), http://www.latimes.com/business/la-fi-dodd-frank-repeal-20170608-story.html.

[29] Financial CHOICE Act of 2017, H.R. 10, 115th Cong.§111(a) (as passed by House, June 8, 2017).

[30] Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 203, 124 Stat. 1376, 1450-1454 (2010).

[31] Financial CHOICE Act of 2017, H.R. 10, 115th Cong.§121(a) (2017).

[32] United States Bankruptcy Code, 11 U.S.C. § 701 *et seq.* and § 1101 *et seq.*

[33] Matt Egan, *The most dangerous part about killing Dodd-Frank*, CNN MONEY (June 12, 2017, 10:18 AM), http://money.cnn.com/2017/06/12/investing/dodd-frank-bailouts-financial-choice-act-ola/index.html.

[34] The SIFI Council regulators include the Secretary of the Treasury, Chairperson of the Federal Reserve, the Comptroller of the Currency, Secretary of the Treasury (chairs the Council), Comptroller of the Currency, Director of the Consumer Financial Protection Bureau, Chairperson of the U.S. Securities and Exchange Commission; Chairperson of the Federal Deposit Insurance Corporation; Chairperson of the Commodity Futures Trading Commission, Director of the Federal Housing Finance Agency, Chairman of the National Credit Union Administration Board and an insurance expert.

[35] Ben Bernanke, *Why Dodd-Frank's orderly liquidation authority should be preserved*, BROOKINGS (Feb. 28, 2017), https://www.brookings.edu/blog/ben-bernanke/2017/02/28/why-dodd-franks-orderly-liquidation-authority-should-be-preserved/.

[36] *Id.*

[37] The "single-point-of-entry" strategy requires the FDIC to resolve a SIFI by making the owners and management accountable for the failure of the company and thereby maintaining the financial stability of the U.S. It requires the

creditors and shareholders to bear the losses of the financial company in accordance with statutory priorities and negate taxpayers'' costs in its implementation. Press Release, Federal Deposit Insurance Corporation, *FDIC Board Releases Resolution Strategy for Public Comment* (Dec. 10, 2013), available at https://www.fdic.gov/news/news/press/2013/pr13112.html.

[38] Aaron Klein, *A primer on Dodd-Frank's Orderly Liquidation Authority*, BROOKINGS (June 5, 2017), https://www.brookings.edu/blog/up-front/2017/06/05/a-primer-on-dodd-franks-orderly-liquidation-authority/.

[39] Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 203(b), 124 Stat. 1376, 1451 (2010).

[40] Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 202(a)(1)(A)(ii), 124 Stat. 1376, 1445 (2010).

[41] Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 202(a)(1)(A)(ii), 124 Stat. 1376, 1445 (2010).

[42] Dodd-Frank Act §202.

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DISCRIMINATION AT PLACES OF PUBLIC ACCOMMODATION AFTER *MASTERPIECE CAKESHOP, LTD. V. COLORADO CIVIL RIGHTS COMMISSION*

by

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The recent decision in *Obergefell v Hodges* [1] provided members of the LGBT community with much needed forward momentum towards equality. In that opinion, the Supreme Court extended the fundamental right of marriage to same-sex couples. Therefore, when the court announced it would review the case *Masterpiece Cakeshop Ltd. v Colorado Civil Rights Commission*, many assumed it would also advance gay rights another step. Given the circumstances of the case, such a perspective was not unrealistic. The case involved two gay men in Colorado who were refused a wedding cake for their marriage ceremony by a Denver bakery. It was exactly this type of blatant discrimination that Colorado's anti-

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discrimination statute (Colorado Anti-discrimination Act also known as CADA) [2]was supposed to prevent. Despite statutory protection, however, similar types of discrimination occur regularly. In its *amicus* brief, for example, the Lambda Legal Defense Fund noted "With disturbing frequency, LGBT people are confronted by 'we don't serve your kind' refusals and other unequal treatment in a wide range of public accommodations contexts." [3] Thus, the Supreme Court had an opportunity to send a message that discrimination at place of public accommodation would not be tolerated.

Therefore, it came as a disappointment to many that the *Masterpiece Cakeshop* decision did not rule in favor of the gay men or protect this class of individuals. Instead, the court chose a very narrow ruling focused on an error in the administrative-level process. The decision missed an important opportunity to establish precedent to protect the LGBT community from discrimination.

HISTORY OF THE CASE

The controversy began in 2012 when David Mullins and Charlie Craig, along with Craig's mother, went shopping for a wedding cake in Colorado. Although they could not get married in that state, they planned a ceremony in Massachusetts with the reception to follow in Colorado. The trio visited a bakery, Masterpiece Cakeshop, Ltd. owned by Jack Phillips. There, they looked at a book of cake designs that Phillips had created. As the discussion ensued, and it became evident to Phillips that the men were talking about a wedding for themselves, he refused to continue the discussion, explaining that the Company had a policy of not creating wedding cakes for same-sex couples. He offered to make them

any other kind of cake, but could not, based on his religious beliefs, make a cake that supported gay marriage.

Significantly, the entire discussion about the wedding cake took less than twenty seconds. There was no discussion of what words, symbols or designs the couple might want. As far as the baker Jack Phillips knew, the cake ultimately requested by the couple could have been a plain white one. But the discussion never reached that point as Phillips ended it as soon as he learned that the men were gay.

Ultimately the men did marry and celebrated with a wedding cake baked by another store in Colorado. But understandably, they did not forget the rejection and discrimination they endured. Subsequently, they filed a discrimination claim with the Colorado Civil Rights Division.

Colorado's anti-discrimination statute states:

> It is a discriminatory practice and unlawful for a person, directly or indirectly, to refuse, withhold from, or deny to an individual or a group, because of . . . sexual orientation . . . the full and equal enjoyment of the goods, services, facilities, privileges, advantages, or accommodations of a place of public accommodation.[4]

The complaint process began by filing with the state's civil rights division, which then investigated and decided whether probable cause existed. Here, after probable cause was determined, Phillips appealed, thus moving the case before the Colorado Civil Rights Commission, an administrative board composed of seven people. During those hearings, which took place over a number of days, the Commission heard testimony from the men and from Phillips about what had transpired at

the bakery. This caused one member of the Commission to make the following statement:

> I would also like to reiterate what we said in the hearing or the last meeting. Freedom of religion and religion has been used to justify all kinds of discrimination throughout history, whether it be slavery, whether it be the holocaust, whether it be—I mean, we—we can list hundreds of situations where freedom of religion has been used to justify discrimination. And to me it is one of the most despicable pieces of rhetoric that people can use to—to use their religion to hurt others.[5]

This statement later served as an important lynchpin when the case was appealed to the Supreme Court. It formed the basis for Justice Anthony Kennedy's majority opinion because it showed such disdain for religion thereby precluding a fair review of free exercise arguments.

The Commission went on to affirm the findings of the Division and held that Phillips violated CADA. It ordered Phillips to design wedding cakes for both same-sex and opposite-sex couples and to train his staff about compliance with the discrimination law. The cake shop appealed that decision to the Colorado Court of Appeals where it was again upheld [6] and then to the United States Supreme Court, which granted *certiorari*. By now, the case had attracted national attention. Many organizations weighed in on a variety of constitutional issues. Over 100 amicus briefs were filed by organizations ranging from the Cato Institute and Foundation for Moral Law to the Transgender Law Center and National Women's Law Center, First Amendment advocates, law professors and a multitude of religious organizations.

PETITIONER PHILLIP'S BRIEF

Phillip's suddenly underwent a complete transformation, from a mere baker to a "cake artist." In the Petition for Certiorari, his attorneys described him as, "Designing and creating specially commissioned cakes…(as) a form of art and creative expression, the pinnacle of which is wedding cakes. Phillips pours himself into their design and creation, marshaling his time, energy, and creative talents to make a one-of-a-kind creation celebrating the couple's special day and reflecting his artistic interpretation of their special bond."[7]

"Coupled with the Petitioner's artistry: they continued, "is the source of his abilities: his deep and abiding religious beliefs. Phillips believes that he …honors God through his work by declining to use his creative talents to design and create cakes that violate his religious beliefs. This includes cakes with offensive written messages and cakes celebrating events or ideas …celebrating Halloween (a decision that costs him significant revenue), anti-American or antifamily themes, atheism, racism, or indecency." [8]

By characterizing Jack Phillips as a creative artist and a deeply religious man, the stage was set for the legal arguments which included three themes. First, that being forced to make a cake for a same-sex wedding violated Phillip's freedom of religion; second that forcing him to make the cake interfered with his free exercise rights; and third, that forcing him to make the cake was in effect making him speak in favor of gay marriage. Because the cake would be seen in public and everyone would know he made it, he was being forced to portray gay marriage positively. In short, the state was coerced or compelled his speech.

The Free Exercise Argument

Scholars may differ on whether or not making a cake is an artistic endeavor protected by the First Amendment. But assuming that it is, then historically, public accommodation laws like Colorado's anti-discrimination statute have withstood First Amendment challenges. If this were not so, then discrimination laws would always be subject to a Free Exercise Clause argument. For example, a store owner could deny selling to African Americans on the basis of religious beliefs or refuse to sell goods to women.

The precedent for this is an opinion written by Justice Scalia in *Employment Division v. Smith.* [9] Two men were fired from their jobs for smoking peyote. They claimed smoking was part of their religious expression. Since the law prohibiting peyote "was generally applicable to the public" and did not signal out a particular religion, it did not violate the free exercise clause. "Generally applicable to the public" is the salient feature when determining if a state statute is discriminatory on the basis of religion. Since the Colorado statute was generally applicable to the public and did not single out a particular religion, then the free exercise argument would fail, as the statute trumped the free exercise argument.

The Coerced Speech Argument

Just as free speech protects the right to *make* pronouncements, so too it protects people from being forced to say anything. Forcing people to make speech in favor of the government is known as coerced speech.

Coerced speech is the opposite of 'free speech.' The idea is that the government uses the actor to make pronouncements he/she would not ordinarily make to advance a cause of the state. Thus, by ordering the cake maker to comply with the Colorado anti-discrimination statute and make cakes for same-

sex couples, the state is arguably forcing him to speak in favor of same-sex marriage. Is it within the power of the government to compel a private citizen "to utter what is not in his mind"?

The parameters of coerced speech have been well-defined by the court in three cases. In *West Virginia State Board of Education v. Barnett*[10] the State of West Virginia mandated that all students state the pledge of allegiance each morning in school. Students who refused to conform were deemed insubordinate and faced possible expulsion while their parents were subjected to fines and possible jail time. Jehovah's Witnesses brought a lawsuit against West Virginia for violating their First Amendment rights because as part of their religious beliefs, the flag is an "image" and saluting the flag a "graven image" in violation of the Bible's Exodus Chapter 20. Mandating that all students recite the pledge was therefore "a compulsion to declare a belief." [11]The Supreme Court agreed holding that

> If there is any fixed star in our constitutional constellation, it is that no official, high or petty, can prescribe what shall be orthodox in politics, nationalism, religion, or other matters of opinion, or force citizens to confess by word or act their faith therein. If there are any circumstances which permit an exception, they do not now occur to us. [12]

Similarly, in *Wooley v Maynard*,[13] Jehovah's Witnesses opposed a New Hampshire statute requiring cars to display a license plate with the phrase "Live Free or Die" embossed on it. In his affidavit filed with the District Court, Mr. Maynard stated, "I refuse to be coerced by the State into advertising a slogan which I find morally, ethically, religiously and politically abhorrent." [14]Likening the license plate to a "mobile billboard" for the state's ideological message the court held that the "State may not constitutionally require an individual to

participate in the dissemination of an ideological message by displaying it on his private property in a manner and for the express purpose that it be observed and read by the public." [15] The court compared the case to *Barnette*, finding that the state was again forcing citizens to be instruments of adherence to an ideological point of view. "In doing so, the State invades the sphere of intellect and spirit which it is the purpose of the First Amendment to our Constitution to reserve from all official control. The right to speak and the right to refrain from speaking are complementary components of the broader concept of 'individual freedom of mind."[16]

Of the three cases, perhaps the most important one dealing with coerced speech is *Hurley v. Irish-American Gay, Lesbian and Bisexual Group of Boston, Inc.* [17]Here, an unincorporated association (the South Boston Allied War Veterans Council referred to as the Alliance) was authorized by the City of Boston to organize and conduct the annual St. Patrick's Day Parade. As such, the Alliance was responsible for deciding what groups could march in the parade. They issued an invitation to members of the public inviting them to march in the parade and accepted nearly every group that applied except the LGBT group. [18]

The Massachusetts courts held that the parade organizers had engaged in unlawful discrimination and ordered them to include the group. The Supreme Court unanimously reversed. It explained that the state applied its public accommodation law "in a peculiar way," [19]when it required the parade organizers to alter the content of their expression to accommodate "any contingent of protected individuals with a message," [20]This violated the First Amendment right of speakers "to choose the content of [their] own message," and decide "what merits celebration,"[21] even if the state or some individuals deem those choices "misguided, or even hurtful." [22]

Hurley is especially applicable to *Masterpiece Cakeshop*, because it is one of the few examples of free speech principles overriding a state discrimination law. Hurley established that "the state cannot apply a public-accommodation law to force individuals engaged in expression to alter what they communicate, much less to celebrate something that they deem objectionable. This is particularly true for speakers, like the parade organizers in Hurley, who exclude no class of people but merely decline to express certain ideas. Similarly, it could be argued that the cake maker would be forced to alter what he (normally) communicated on his cakes if the court enforced the Colorado statute against his business.

THE U.S. SUPREME COURT MAJORITY DECISION

Justice Kennedy wrote for a 7-2 majority reversing the decision of the Colorado Civil Rights Commission. At first blush, the reversal appears to allow *Masterpiece Cakeshop* to discriminate against customers based on sexual orientation. Yet the court never reached a decision about whether the bakery's free exercise and free speech rights were violated. The court never addressed the substantive questions in the case.

In his opinion, Justice Kennedy began by reassuring the LGBT community. \

> Our society has come to the recognition that gay persons and gay couples cannot treated as social outcasts or as inferior in dignity and worth. For that reason the laws and the Constitution can, and in some instances must, protect them in the exercise of their civil rights. The exercise of their freedom on terms equal to others must be given great weight and respect by the courts.[23]

The primary issue in the case, and the one that most followers of the court had hoped would be resolved was whether places of public accommodation, like a store, give up religious beliefs in favor of protected classes? Could the owner of a cake shop refuse to make a wedding cake for a gay couple despite Colorado's statutory protection of gays at places of public accommodation?

As a rule, when there is a clash between business owners and protected classes, the protected classes will prevail as long as the statute giving them protection is not an arbitrary or biased law. "While those religious and philosophical objections are protected, it is a general rule that such objections do not allow business owners and other actors in the economy and in society to deny protected persons equal access to goods and services under a neutral and generally applicable public accommodations law."[24] What constitutes a 'neutral and generally applicable public accommodations law' becomes key in deciding the outcome.

Phillip's case, however, might be an exception according to Kennedy, because "the baker found it difficult to find a line where the customers' rights to goods and services became a demand for him to exercise the right of his own personal expression for their message, a message he could not express in a way consistent with his religious beliefs."[25] And it was exactly that decision that provoked such interest in the case. If on the one hand the statute is enforced, then the free exercise clause does not protect one's religious interests; but if religion is allowed to excuse shopkeepers from compliance, this allows shopkeepers to discriminate with impunity.

Unfortunately, the court never reached the issue of free speech, freedom or religion or whether the statute was 'neutral

and generally applicable.' And herein lies the disappointment with the decision. The court harkened all the way back to the hearing that had taken place many years before at the Colorado Civil Rights Commission. Recall that when the case was initially reviewed there, one of the commissioners made the following statement:

> We can list hundreds of situations where freedom of religion has been used to justify discrimination. And to me it is one of the most despicable pieces of rhetoric that people can use to—to use their religion to hurt others. [26]

The court found this statement was evidence of a profound disrespect for the baker's sincere religious beliefs, thus tainting the board's decision. "The baker was entitled to a neutral decision maker who would give full and fair consideration to his religious objection."[27] The "clear and impermissible hostility" violated the baker's free exercise rights. Because the hearing board's conduct was prejudiced against the cake maker, the court did not reach a decision weighing the statute against free exercise rights.

> The delicate question of when the free exercise of his religion must yield to an otherwise valid exercise of state power needed to be determined in an adjudication in which religious hostility on the part of the state itself would not be a factor in the balance the state sought to reach. That requirement, however, was not met here. When the Colorado Civil Rights Commission considered this case, it did not do so with the religious neutrality that the Constitution requires.[28]

The court said that the inconsistent treatment by the Civil Rights Commission showed hostility towards Phillips' religious faith. Colorado had violated its duty "not to base laws or regulations on hostility to a religion or a religious

viewpoint."[29] The state must "proceed in a manner neutral toward and tolerant of Phillips' religious beliefs." The commission had been "neither tolerant nor respectful"; it had proceeded on the basis of "a negative normative 'evaluation of the justification' for his objection" (quoting *Lukumi*). As a result, the court did not further examine the free exercise issues, leaving the question of which should prevail---the state discrimination statute or the Petitioner's religious rights---unanswered.

Finally, because the Colorado Commission had engaged in discriminatory behavior toward Phillips (the baker), the Court overturned the decision of the Commission. This left no other options for the Mullins and Craig to appeal or have a re-hearing, to a close their discrimination complaint.

The Kagan Concurrence

Justice Kagan explained in her concurrence that she wished to elaborate on one basis of the Court's holding. She wanted to distinguish the current case from one involving "three other bakers" also in Colorado, a case that was working its way through the courts around the same time as *Masterpiece*. The "three bakers" refers to a case involving a man named Mr. Jack who went to three different Denver, Colorado bakeries and asked each one to make him a cake that included two Bible verses: "God hates sin. Psalm 45:7" and "Homosexuality is a detestable sin. Leviticus 18:2[2]" and then place two grooms holding hands on the top with a red "X" placed over them.[30] Each of the three bakeries refused and Mr. Jack then brought his case to the Colorado Civil Rights Commission and Division claiming religious discrimination.

In direct contravention to its holding in *Masterpiece*, the Commission and Division both held that the three bakeries

did *not* violate Colorado's discrimination statute. This was so because the bakeries could refuse to sell cakes with these particular messages to *any* customer requesting them.

To Kagan, the standard that the public accommodations law must be "neutral and generally applicable" means that all customers who come into a store must be treated the same. Therefore, she saw no contradiction between *Masterpiece* and the "three bakeries." In *Masterpiece*, the bakery was in the wrong because it would make wedding cakes for some people (heterosexuals) but not others (homosexuals); this disparate treatment is discrimination. But in the "three bakeries" none of the bakeries would make the cakes with the hateful sayings on them for any customers, thereby treating all customers the same. Therefore, the "three bakeries" did not discriminate.

The Gorsuch Concurrence

Justice Gorsuch on the other hand, disagreed with Kagan's analysis. He emphasized the viewpoint of each cake maker and whether the requested cake violated *that person's* own beliefs. For example, in the "three bakers case" Mr. Jack requested cakes with messages inscribed on them denigrating same-sex marriage. All three bakeries refused because *they the bakers*, found the request offensive to their own beliefs. Gorsuch then compared the three bakers' refusal to that of Mr. Phillips, who declined to make a cake with a message in favor of same-sex marriage, because it violated his own beliefs. How could the three bakeries be free from discrimination for refusing to make the cakes when Phillips was discriminatory for refusing to make the cake? Those are opposite results for the same act. To Gorsuch this contradiction by the Commission showed that it made its decisions based on whether or not it agreed with the

message. “The Commission could not have it both ways, setting a different standard when the message was one the Commission supported (the “three bakers”) but finding discrimination when the request went against gay people. Gorsuch likened the Commission’s actions to a sliding scale that resulted in unfair and disparate decisions based on the Commission’s own prejudice.

The Ginsberg Dissent

Justice Ginsberg, in contrast to Gorsuch, viewed this case from the standard of equal treatment. When the baker refused to make a cake for the two men, it was not the message on the cake, but their status as a gay couple that was significant. Phillips discriminated because he would make a wedding cake for some people (heterosexuals) but not others (homosexuals). Treating people differently because of their sexual orientation is a violation of the Colorado statute and thus the case should not have been overturned by the Supreme Court.

In the Mr. Jack case, the baker refused to make a cake with a hateful message. Because that baker would not make the “hateful cake” for anyone; therefore, all customers were treated equally. Since they were all treated equally, no one was discriminated against and there was no statutory violation. The Commission should have found such.

In short, it is not about speech or religion, but rather how the law is applied that matters, and equal treatment under the law is the test of discrimination.

CONCLUSION

Shortly after filing his Petition with the Supreme Court, Jack Phillips received a call at his bakery. This time the person on the other end of the phone asked Phillips if he would make her a cake with a blue exterior and a pink interior. Then the

caller disclosed that the color scheme represented her transition from a male to a female. Phillips declined to make the cake [31] citing his religious beliefs as the reason.

This time, Phillips took the offensive and filed a lawsuit in Federal District Court in Denver alleging that Colorado officials are on a "crusade" against him. He argued that because he refuses to make cakes that violate his religious beliefs, the state is "out to get him". In recent years, his lawyers say, he has been targeted by potential customers eager to test the limit of the law.[32]

There is a very good reason that Phillips is back in court so soon after the Supreme Court decision. The court failed to answer the most important question at the heart of the case, namely, can places of public accommodation discriminate against protected classes? Instead the court chose to side-step the question. What impact does this have? For Phillips, he has become a target by anyone in the LGBT community who wants to prove a point and use him to litigate. For those not inclined to personally test the law, the door appears to be open to use religion as a reason to discriminate with impunity. One can imagine numerous scenarios in which business owners profess a religious belief to avoid serving any number of people. A dry cleaner who hates Muslims can claim his religion does not permit him to clean clothes of another faith; a doctor may refuse to treat a pregnant woman who is not married on religious grounds; the list is endless. Since the court provided no guidance on the issue, nor admonishment of Phillip's actions toward the gay men, there appears to be at least a tacit nod of approval for his role in violating the statute and blatantly discriminating.

Not only may the court be reflecting its own conservatism, but the allowance of discrimination and bigotry may also reflect the country's leaning toward a more conservative view

of gay rights. A poll taken after the *Masterpiece* decision showed that close to half of all Americans (46 %) believe that the owners of "wedding-based businesses, such as caterers and bakers, should be allowed to refuse service to same-sex couples if doing so violates their religious beliefs." [33] The poll was conducted by the Public Religion Research Institute and it contains alarming information including data that shows "Black American's support for conservative business owners like Phillips rose from 36% in 2017 to 45% this year while Hispanic Americans support rose from 26 percent to 34 percent." [34] Given the history of discrimination against Blacks and Hispanics, the fact that these groups support discrimination against another protected class is surprising.

Some court watchers believe that *Masterpiece II* will likely end up at the Supreme Court, but the decision this time will address religion and discrimination against gays. Given the conservative nature of the court, that may not be good news for the LGBT community. If public perception is any indication of where the court would land, religious freedom certainly seems to be the "winner." Just look at recent headlines regarding the second case against the baker:

- *Colorado end your crusade against Masterpiece Cakeshop*[35].
- *Colorado Hauls Vindicated Christian Baker Back to Court*.[36]
- *Hostility Unabated: Colorado seeks to punish cake artist Jack Phillips*[37]

If the past behavior of the court is any indication, then the fact the court found that the Colorado Civil Rights Commission showed prejudice based on one statement made by a Commission member regarding the use of religion to justify

discrimination is alarming. Compare that finding to the court's reasoning in *Trump v. Hawaii*, upholding the Muslim travel ban. In that case, despite President Trump's frequent anti-Muslim statements, the court voted 5-4 to impose a travel ban. This is clearly irrational when on the one hand a statement by a commissioner results in a finding of religious hostility but an entire political campaign and election based on banning a religious groups is not hostile. "In contrast to *Masterpiece Cakeshop*, the evidence of anti-religious animus in the Muslim ban case is unambiguous and consistent. And it all flows from President Trump, the person singularly responsible for the policy. He formally called for a "shutdown of Muslims entering the United States" in a statement that remained on his campaign website well into his presidency."[38]

Finally, if the Supreme Court does allow shop owners to use religion as a basis for discrimination, it is difficult to see where any limits would exist. Once the doors are open to discriminate against one group, then the underpinnings are in place to extend legalized discrimination against others. One reason for the supposed equal application of the law is to prevent such an outcome. Yet, given the actions of this court, the likelihood of a future outcome consistent with precedent seems unlikely.

ENDNOTES

1 *Obergefell v. Hodges*, Oyez, https://www.oyez.org/cases/2014/14-556 (last visited Jan 21, 2019).
2 CO Rev Stat § 24-34-601 (2016)
3 Brief of *Amici Curiae* Lambda Legal Defense and Education Fund, Inc. Family Equality Council, Et. Al. In Support of

Respondents, *Masterpiece Cakeshop Ltd. v Colorado Civil Rights Commission*, No. 16-111 (October 30, 2017)
4 CO Rev Stat § 24-34-601 (2016)
5 *Masterpiece Cakeshop, Ltd. v Colorado*, 584 U.S.------- (2018)
6 *Craig v. Masterpiece Cakeshop*, Inc. 370 P.3d 272 (2015)
7 Petitioners' Masterpiece Cakeshop, Ltd. and Jack C. Phillips' *Petition for a Writ of Certiorari*, *Masterpiece Cakeshop Ltd. v Colorado Civil Rights Commission*, No. 16-111 (October 30, 2017).
8 Id.
[9] *Employment Division, Department of Human Resources of Oregon, Et. Al. v. Smith et.al.*, 494 U.S. 872 (1990).
[10] 318 U.S. 624 (1943)
[11] *Id*. at 640
[12] *Id*. at 642
[13] 430 U.S. 705 (1970)
[14] *Id* at 714
[15] *Id*.
[16] *Id*.
[17] 515 U.S. 557 (1995)
[18] *Id.* at 561-65.
[19] *Id.* at 558
[20] *Id*. at 561
[21] *Id* at 574
[22] *Id*.
[23] 584 US ---- (2018).
[24] *Id*
[25] *Id*
[26] *Id*
[27] *Id*
[28] *Id*
[29] *Id.*

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[33] Carol Kurvilla, *More People Now Support Allowing Businesses to Refuse LGBTQ Customers: Survey.* The Huffington Post (August 3, 2018) @ https://www.huffingtonpost.com/entry/slightly-more-americans-now-think-christians-shouldnt-have-to-serve-queer-customers-survey_us_5b6498b7e4b0de86f4a10abf

[34] *Id*

[35] James Gottry. *Colorado, end your crusade against Masterpeice Cakeshop* , The Hill (August 17, 2018) @ http://thehill.com/opinion/civil-rights/402114-colorado-end-your-crusade-against-masterpiece-cakeshop

[36] Jay Hobbs, *Colorado Hauls Vindicated Christian Baker Back to Court on New Trumped-Up Charges*, The Federalist (August 17, 2018) https://thefederalist.com/2018/08/17/colorado-hauls-vindicated-christian-baker-back-court-new-trumped-charges/

[37] *Hostility Unabated: Colorado Seeks to Punish Cake Artist Jack Phillips Again.* Alliance Defending Freedom, Mercatornet (August 17th, 2018) @ https://www.mercatornet.com/conjugality/view/hostility-unabated-colorado-seeks-to-punish-cake-artist-jack-phillips-again/21617

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[38] Mach, Danier. *Supreme Court only sees religious bigotry when it wants to*. News-Herald (August 19, 2018) @http://www.thenewsherald.com/opinion/supreme-court-only-sees-religious-bigotry-when-it-wants-to/article_441be6a6-a001-11e8-bede-1fa410c5f6fc.html